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THE JOURNAL OF Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

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OCTOBER 1957 • VOL. 7 • NO. 4

THE JOURNAL OF *Taxation*

THE JOURNAL OF TAXATION is published monthly by The Journal of Taxation, Inc. Publication office, 320 North Sixth Street, Paterson 2, New Jersey; editorial office, 147 East 50th Street, New York 22. Telephone PLaza 3-8258. Material for publication is welcomed, either technical manuscripts or news items of interest to professional tax men. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts.
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Application pending for reentry at Paterson, N. J., March 13, 1956.

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Sales and Use Taxes:

When, where and to what transactions do they apply?

by JOHN F. DUE, EUGENE GREENER, JR., CLYDE L. BALL, ARTHUR H. NORTHRUP, GEORGE D. BRABSON

The rules governing sales and use taxes are fraught with almost as many variations as there are states. Definitions of sale and use overlap; double taxation occurs; different jurisdictions measure in different ways the amount to be taxed; and exemptions suffer from a lack of uniformity. Nevertheless there are basic principles which every tax practitioner must understand if he is to handle these taxes successfully. It is these general rules and their important exceptions which are here lucidly explained in an adaptation of a symposium developed by the Vanderbilt Law Review, (9 Van. L. Rev. 123), and offered here with their permission.

Sales taxes; three different types prevail in local taxation today

by **JOHN F. DUE**

SALES TAXATION has, in the course of 25 years, become the chief single source of state tax revenue, yielding about $2.5 billion or 21% of total state tax revenue in the 1955 fiscal year. In the 31 states using the tax, it yields approximately one-third of revenues. The tax has also been growing in importance at the local level, yielding about $400 million, the bulk of this being obtained by a relatively few large cities. The Federal Government has never employed a general sales tax, despite considerable pressure for the tax at various times.

The term *sales tax* generally refers to a tax imposed upon the sale, the gross receipts from the sale, or the purchase of all or a wide range of commodities. It does not refer to fractional-rate taxes on gross receipts levied in the form of business-occupation taxes. These latter taxes may in fact have the same economic effects and pattern-of-burden distribution as sales taxes, but it is customary to regard them as a form of business taxation rather than as sales taxes. The line between these and sales taxes is not entirely well defined, and a few states couple the two forms of tax together in the same tax law. But most of the taxes in present use fall clearly into one category or the other.

The sales tax, as defined, is classified as a form of consumption tax, under the presumption that the burden of the tax is typically shifted forward to the purchasers of the products, and thus the final burden of the tax is distributed in proportion to consumption expenditures. It is recognized, of course, that the shifting of the tax is by no means perfect or complete in all cases, but the assumption is generally regarded as a reasonably appropriate one under most circumstances.

Sales taxes are distinguished from *excise taxes,* the other principal form of consumption tax, by their greater coverage. This term is usually restricted to levies imposed upon the sale of particular commodities or closely related groups of commodities. A very widespread excise system would of course closely resemble a general sales tax, but as a matter of fact in the United States, and particularly at the state level, the excises are limited in scope.

Sales taxes can be classified into two general types on the basis of whether or not commodities are subject to the tax more than once as they pass through production and distribution channels. The *multiple-stage* sales tax is applied to transactions at more than one stage in production and distribution channels, and, in the most complete version, to those at all stages. These taxes are often known as turnover or transactions taxes. The basic objection to them is obvious: serious discrimination occurs against nonintegrated business firms, and substantial incentive is given toward increased integration.

The *single-stage* sales tax applies only once to each commodity as it passes through production and distribution channels. Single-stage sales taxes may be imposed at any one of three possible levels:

1. The sale by the manufacturer.
2. The wholesale level, or more precisely, the last wholesale transaction, that is, the purchase by the retailer, whether from a manufacturer or wholesaler.
3. The retail sale. The retail sales tax is the familiar form, as all of the state sales taxes, strictly defined, take this form. Some of the states supplement their retail sales taxes with low-rate gross receipts taxes on wholesalers, manufacturers, or both, and thus give the taxes the nominal appearance of mul-

tiple-stage turnover taxes. But the levies on the nonretail levels have only fractional rates, and are generally regarded as forms of business-occupational levies used as a substitute for corporation-income or capital-stock taxes.

Contrasted to the multiple-stage taxes, the single-stage form, regardless of the level at which it is imposed, has very significant advantages. The incentive toward integration is avoided, as well as the discrimination against small nonintegrated businesses. The relative burden on consumer expenditures on various commodities is much less uneven; with the multiple-stage taxes the relative overall burden will depend upon the number of stages through which the commodity passes on the way from initial production to final consumption. Administration is in many respects simpler. There are fewer diverse types of firms from which to collect tax, and the complications which are typically introduced into multiple-stage taxes to avoid severe injury to certain groups of taxpayers are avoided.

Among the various forms of single-stage taxes, the manufacturers' sales tax offers the one advantage of permitting collection from a relatively small number of taxpayers, the bulk of the revenue coming from large firms. On the other hand, the retail sales tax avoids the tendency for the tax to pyramid, at least for temporary periods, through application of percentage markups by wholesalers and retailers to purchase prices which include tax elements; it ensures a more uniform ratio of tax burden to consumption expenditures on various goods (assuming that the tax is shifted) and thus avoids the sort of discrimination which arises with the excises; and it avoids the very troublesome problem of ensuring equity among various competing firms utilizing different distribution channels which arises with the manufacturers' sales tax. The latter tax tends to penalize the firms selling directly to retailers or consumers at prices higher than those charged wholesalers by competing manufacturers, unless adjustment of price for tax purposes is made. Finally, in the case of the states, the complications of interstate transactions make use of the retail level highly desirable, since relatively few retail sales are interstate in character compared to the number of such sales by manufacturers or wholesalers.

In recent years, a new variety of sales tax which has some aspects of both single-stage and multiple-stage taxes has been developed on the basis of a principle suggested several decades ago. This is the value-added tax, now employed in France. It is the basis of the Michigan business-receipts levy, usually regarded as a business-occupation tax rather than a sales tax, but obviously closely related to the latter. Under the value-added principle, each firm is taxed on the value added by the firm's activities to the materials processed or commodities handled. Under the Michigan system, each firm calculates the amount of value added by subtracting from its gross receipts the amounts paid for materials and other commodities (other than equipment) purchased, as well as interest, rent, and taxes. The tax rate (now 6½ mills, except for public utilities) is applied to this figure of value-added.

As a sales tax, the value-added levy, if carried throughout production and distribution channels, would produce the same overall distribution of burden as a retail sales tax, since the sum of the values added at all production and distribution stages is equal to the retail selling price. If the value-added tax were confined to the manufacturing level, the net effect would be the same as that of a manufacturers' sales tax on finished products. The primary advantage offered by the value-added form is the spreading of the impact of the tax over a larger number of firms, rather than having it concentrated on a particular one. This is an important advantage to many European countries, in which collection of high-rate taxes on limited classes of firms is difficult, but it is of little real advantage in the United States. The Michigan tax has not typically been regarded as a sales tax, but as an occupational levy on business, a charge for the privilege of conducting business in the state.

[*Mr. Due is Professor of Economics at the University of Illinois.*]

Use tax causes multiple burdens for taxpayers, collection problems for states

by EUGENE GREENER, JR.

THE USE TAX was conceived as a necessary supplement to the successful administration of the sales tax. If for some reason a sale at retail of tangible personal property escaped tax, the use, the consumption, the distribution, and the storage of the property were to be taxed after it came to rest in the state and became a part of the mass of property.

But as the poet Robert Burns intimated about the best-laid plans, the perfect scheme proved to be imperfect. For out of the relationship between the sales tax and the use tax, problems arose. They were mainly of two types: the constitutionality of the statute or of its application, and the administration and collection of the tax, with particular emphasis on combating tax evasion.

Sales and use taxes have been adopted by 32 states and various cities. Many cities have the use tax and the sales tax, under the theory they are protecting the local merchant by providing a complete and symmetrical tax method. But the opposite has often been the result.

For example, if the canny consumer lives in a city with no use tax (whether or not a sales tax is in effect), he simply buys elsewhere, where there either is no sales tax or where the sales tax rate is lower. But if he has bought out of the city and his city has a use tax, rather than meekly paying the use tax, he makes the city "come and collect it." Now the city can do this easily, if the selling company has a branch or property in the city, by making the retailer a "dealer" and collecting on many such transactions at one time.

But often the seller does not collect the tax. Either the consumer is not a resident of the same city or the seller delivers by mail or carrier to the out-of-city consumer and has no property in the city of the consumer's residence. As a practical matter, the city cannot collect a use tax from each of thousands of individual consumers on innumerable transactions.

Constitutional questions

That the sales tax is an excise or privilege tax and not a property tax

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(which state constitutions require to be uniform and equal) has been an easy decision for courts of last resort. The sales tax is a tax on the privilege of selling at retail, and this is true even though the burden is probably shifted to the ultimate consumer.

Uniformly, the use tax has been held to be an excise, rather than a property tax. Logically, this conclusion is probably harder to defend. For although the use tax has been conceived as the alter ego of the sales tax, it is generally collected from the ultimate consumer.

But theoretically isn't the use tax a true property tax? No, say the courts. Because "use" is generally defined as every incident of ownership, except selling at retail in the regular course of business. Or as Mr. Justice Cardozo said: "The privilege of use is only one attribute, among many, of the bundle of privileges that make up property or ownership. A state is at liberty if it pleases, to tax them all collectively, or to separate the faggots and lay the charge distributively." And since use is one attribute short of the full bundle of property rights, and the legislatures have declared use, as so defined, a privilege, the tax, ergo, is an excise tax.

Primarily, the Federal constitutional questions involved by *the relationship* of the sales and the use tax boil down to taxation by more than one state of a single transaction, or the so-called problem of multiple burden. To consider this problem in its proper perspective, one should keep in mind the continuing fight that is and must be waged against sales- and use-tax evasion. For the sake of this discussion, it is assumed that the burden of the sales tax is shifted to the ultimate consumer. It is submitted that if this assumption be incorrect, the courts have wasted a vast amount of time.

Many states provide a compensatory feature to prevent a multiple tax burden. If, on the same transaction, another state collected tax greater than the tax in the state concerned, then no tax will be collected. If a tax has been collected in another state but the tax is less than that of the state concerned, there will be collected only the difference between its tax and the tax already paid.

Unfortunately more than half of the use tax states do not have any such compensating feature. We must first face whether or not such a feature is necessary to assure Federal constitutionality of a sales and use tax statute and further what alternative might be available.

In an article entitled "The Future of Use Taxes," Mr. Brown[1] is of the opinion that multiple burden, if it occurs solely as the result of the several intrastate aspects of a transaction, is constitutional. If a resident of state *A* personally goes to state *B*, a sales tax state, makes a purchase, pays a sales tax and receives delivery in state *B*, and then returns with his property to state *A*, state *A* may impose a use tax on the same piece of property, give no credit for the sales tax that has been paid, and no constitutional violation would have occurred. And local merchants would have been protected. To me, this conclusion sounds doubtful, and the reader is referred to an article by Mr. Snell,[2] wherein he expresses the opinion that the second taxing is discriminatory "by virtue of the interstate goods' bearing a tax burden to which local purchases are not exposed."

Potential vs. actual burden

It is to be noted that when the Supreme Court okayed the use tax in the *Henneford* case,[3] the statute in question did have a compensatory feature, but the Court did not say it would have been bad without this. And the Court okayed the California use tax statute without a compensatory feature because, it said, it would not void a statute based merely on a *potential* multiple burden of taxation on interstate commerce. And, further, it has been said that the Supreme Court itself is divided as to whether *potential* risk of double taxation will invalidate, or whether *actual* burden is the standard.

About the only safe conclusion seems to be that each factual situation will be examined by the courts, and, if a multiple burden is found to exist, the application of the tax in that situation will be voided. The overall trend more and more is to uphold the tax, or, as it has been said, interstate commerce is paying its way. But the factor of the general *appearance* of the whole transaction remains important, and the judges of the Supreme Court themselves differ over whether actual or potential burden is the standard to cause invalidity.

To play it safe, to avoid becoming embroiled in this shifting situation, and to prevent evasion, several procedures for inclusion in the pertinent statutes have been devised.

The compensatory feature, also known as the credit allowance, has been adopted by some states. On its face, it seems to be a simple and effective device. Alas, it has been unpopular, because some states worry that it encourages extra-state purchasing. It is argued that if no credit is allowed, the consumer will buy at home to escape paying two taxes. It can be contended, however, that this argument does not actually have too much merit, for the consumer simply can order for delivery by mail or common carrier (and probably pay no sales tax) from an out-of-state retailer with no establishment in or connection with the buyer's home state. Since it is difficult to collect the use tax from an individual, this consumer might pay neither tax.

Another suggested procedure is apportionment of the tax so that it would be collected only on that portion of the price attributable to activities within the state. This would seem bad if interstate commerce transactions are subjected to a tax but local purchases are not. If apportionment were to apply to the tax rather than to the purchase price of the article, and if in no event could the burden be more than the full tax of a single jurisdiction, this device might be constitutional. But it still poses difficult, if not impossible, administrative burdens, such as arriving at a fair apportionment formula.

Primarily to prevent evasion but also apparently to avoid multiple burden taxation is a third scheme. That is the taxing of use or consumption at a higher rate than if the tax had been paid at the time of the sale. Assuming no sales tax by the out-of-state seller's state, proponents of the scheme hope that the seller will, in order to retain the goodwill of the buyer who will be taxed at a higher rate, pay the tax. This hope seems exceedingly naive, except in unusual cases. Because it treats inter- and intrastate transactions the same way, however, the device may pass the constitutional test.

Can the use tax be collected constitutionally from an out-of-state seller and under what circumstances? If the states

[1] 8 Law & Comtemp. Prob. 495 (1941).
[2] 27 *Taxes* 37 (1949).
[3] Silas Mason Co., 300 U.S. 577, 582 (1937).
[4] Sears, Roebuck & Co., 312 U.S. 359 (1941).
[5] General Trading Co., 322 U.S. 335 (1944).
[6] Miller Bros. Co., 347 U.S. 340 (1954).
[7] 276 N.Y. 198, 11 N.E. 2d 728 (1937).

do not have the right to collect it evasion would run wild.

As early as 1941, such collection was validated by the Supreme Court where the foreign corporate seller was also "doing business" in the levying state, although the buyer had no dealing whatsoever with the local branch.[4] Later the Court went further. It allowed collection from an out-of-state seller neither qualified to do business in the state nor maintaining any office there.[5] This decision was based on the grounds that the seller had traveling salesmen in the state, that all sales were subject to out-of-state acceptance, and the property was shipped by common carrier or mailed in.

Thus, the Court has gone very far in aiding in the collection of the tax. This aid is no doubt reflected in the productivity of the tax. But very recently a warning note has been sounded. There is a limit. It was held in the *Miller Brothers* case[6] that an out-of-state Delaware seller with practically no connection with Maryland did not have to collect Maryland's use tax.

Administration and collection problems

Evasion of the sales-use tax is a major problem. The use tax was conceived because of the extent of the evasion. Undoubtedly it has helped achieve the goal. Despite the use tax, however, a substantial amount of total or partial evasion continues. Much evasion succeeds because of the tremendous difficulty in collecting the use tax from the millions of individual consumers on the hundreds of millions of transactions.

The taxing authorities have therefore concentrated on what is easily collectible. And that is why the sales tax has remained so popular. As far as the use tax is concerned, collection has been from other than the consumer wherever possible; even from an out-of-state seller, it has proved to be an economical and fairly easy method of collection.

From the point of view of the most return at the least cost, the best advice may be: continue as before by collecting the sales tax in full, and collect the use tax from other than the consumer.

The one exception might be to set up a system whereby, even direct from the consumer, the use tax should be collected on large items, such as automobiles. Where the return on one transaction is as much as $30 to $150, the effort is justified. The 1955 Tennessee legislature, adopting a common device, made it unlawful for any county court clerk to accept an application for a certificate of title for a motor vehicle unless the applicant could prove payment of the sales or use tax or show authority from the Commissioner to file without payment.

Even on large purchases, direct collection from the consumer is difficult. This device suggests a fairly easy method of checking on the purchase and use of other larger items, such as airplanes and boats, which must be licensed by some governmental agency. Direct collection of the use tax, however, on the millions of small purchases remains economically unfeasible, even if possible.

Mention should be made of how two states, California and Mississippi, in a somewhat novel manner attempted to force collection of the use tax from out-of-state sellers. Both were apparently unsuccessful. California threatened to ruin the out-of-state seller's local business by prosecuting its customers if the seller would not collect the tax. Mississippi obtained a mandatory injunction against the commission of a crime, which itself is a questionable procedure.

When is a sale a sale? Determining what transactions are subject to sales tax

by CLYDE L. BALL

EACH STATE which has adopted some form of sales tax has also adopted its own individual definition of the term "sale" or "retail sale." So long as a tax upon a business transaction does not offend some constitutional principle, a legislature is free to include the transaction within its statutory definition of a sale for purposes of an excise tax levy. Synthesis of these varying statutes into an acceptable general statement is hardly possible; about the most one can do is to classify and catalogue.

The problems which arise may be placed in two general categories: transactions which are not in form a sale at all, but which may be within the scope of the taxing statute; and transactions which clearly are sales, but which may be without the scope of the taxing statute because the sale element is but an incident to a service or repair transaction, or because the sale is something other than a retail transaction. These two categories can be broken down into subclassifications which overlap each other to a degree, and which may cut across the boundary between the general classifications.

The Uniform Sales Act defines a "sale" as "an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price." Contracts for the rendition of services, and contracts of rental, leases and license to use do not come within this definition, but they may nevertheless be subject to a "sales" tax. Where such transactions are taxed because the legislature, as a matter of taxing policy, defined the term "sale" to include other types of transactions, the result may be simply a matter of routine statutory application and may pose no particular problem. There is another type of situation, however, where a nonsale transaction is taxed because either the legislature or the courts, or both, have felt that the transaction was consummated outside the framework of a sale in order to avoid the tax, or because the practical substance of the transaction is the same as that under a sale, and the transaction should, as a matter of economic justice, bear the same tax burden.

Service transactions

When a transaction does not involve any transfer of property, the transaction will not be taxable in the absence of special statutory provision. The services of a barber in cutting hair, or of a jeweler in cleaning a watch would not be taxable.

In one of the leading cases involving services, *Dun & Bradstreet, Inc.*[7] the New York court ruled that the financial information service rendered by Dun & Bradstreet to their subscribers was a nontaxable service, despite the fact that reference books containing financial information were delivered to the subscribers. These books could not be obtained without subscribing to the service, and no separate charge was made for them.

Four significant fact elements appear in the case: (1) The subscriber could

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make no proper use of the books except to extract information therefrom for his own use. Under the contract he could neither exhibit the books to anyone else nor sell the information he extracted from them. (2) Title to the books was not transferred. (3) The service could have been rendered, albeit at much greater expense and effort, without transferring the books at all. (4) No separate charge was made for the use of the books as distinguished from the service.

Is service confidential?

If an information service is not confidential, so that the subscriber may assign or exhibit for his own profit the reports which he receives from the service, then it apparently loses its character as essentially a service and becomes taxable. The subscriber is held to have purchased the product of the research and not the services which went into the publication. The significance of this confidential, nonassignable characteristic of the information reports is further emphasized in a case involving Babson's Business Reports. In *Business Statistics Organization, Inc.*,[8] the publisher contended that the reports were exempt from taxation under a provision of the New York City law exempting periodicals. The city contended that because the reports were designated by the publisher as "confidential" they could not be classed as periodicals. The New York court ruled that the reports were not confidential in any true sense, and that, therefore, they could qualify as periodicals, other conditions being satisfied.

Absent the confidential factor, what are the characteristics of a document which determine whether the recipient has bought the document or the services which went into its preparation? If a report is prepared at the special request of the client, to fit his particular requirements, and is not of significant intrinsic value apart from this special situation, it is an incident of a service and should not be taxable as a sale, no matter in what form it may be transmitted—printed, type-written, or on tape, for example. The fee paid to an official court stenographer for a transcript of the minutes of a court is paid for the services of the stenographer, not for the paper pages on which the report is transmitted. The same result would seem reasonable in the case of an attorney who prepares a will or other legal document for a client, or physician who writes out a prescription or renders a medical report in writing, or an investigator who prepares reports for a client.

The fact that skilled professional work and knowledge go into the preparation of an article does not mean that the article is always transferred as an incident to a service transaction. For example, the lawyer who prepares and delivers to a client a printed will as a part of his professional service to the client might also prepare and publish a form book on wills which would be available to any person who might choose to buy it; such a buyer would obtain the benefit of any professional skill of the draftsman in a general way, but the professional attorney-client relationship would be absent. The book, and not the services, is the subject of the transaction, which is an ordinary sale.

The true test then is one of basic purpose of the buyer. When the product of the service is not of value to anyone other than the purchaser, either because of the confidential character of the product or because it is prepared to fit the purchaser's special need, this fact is evidence tending to show that the service is the real purpose of the contract. When the purpose of a contract is to produce an article which is the true object of the agreement, the final transfer of the product should be a sale, regardless of the fact that special skills and knowledge go into its production. Under this analysis, printing work, done on special order, and of significant value only to the particular customer, is still a sale. The purchaser is interested in the product of the services of the printer, not in the services per se. Similarly, it would seem that contracts for custom-produced articles, be they intrinsically valuable or not, should be classified as sales when the product of the contract is transferred.

Trade services

Another type of service transaction involves the transfer of tangible personal property by rental or license to use, the transferor performing some significant service with respect to the thing transferred. Linen and diaper services are common examples. The housewife who subscribes to a diaper service accomplishes two ends: she does not have to buy diapers, and she does not have to launder them. If inquiry were made, she would in all probability unhesitatingly announce that the service—the laundering—more significantly motivates her decision to subscribe to the service. Nevertheless, such a service has been held taxable on its gross proceeds under a statute taxing the rental of tangible personal property. In Philadelphia, a linen service was taxed on gross proceeds, even though it showed that only about 20% of its charges was for replacement of the linens. New York City, from whom Philadelphia borrowed its sales-tax law, had declared by administrative regulation that linen services are not taxable. The Pennsylvania court considered the New York regulation to be inconsistent with the New York cases holding that rentals of motion-picture film for the purpose of exhibiting it to audiences are taxable.

Is service only purchased

It is not necessarily inconsistent to treat film rentals and linen services differently under a tax statute; there is a difference between the two types of transactions. The linen-service customer purchases a service which must be performed with each delivery—the linens must be laundered. The customer may or may not receive the same linens repeatedly, the supplier performing a laundry service to make the linens usable. The film renter expects film delivered to him to be in a serviceable condition, but after each exhibition it is not necessarily returned to the distributor for servicing. Repair or cleaning of film is not what the customer is primarily buying.

If he is buying any service at all, the film customer may be purchasing the services which went into the making of the film. In *Washington Times-Herald, Inc.*,[9] the court ruled that a newspaper which purchased comic strip mats from a syndicate under contracts granting the right to reproduce the strips in one issue of the paper had purchased the services of the artist who drew the strip. Lack of privity between artist and newspaper, the court said, constituted no obstacle. Under this decision, the syndicate had apparently purchased the services of the artist, stored these services in the form of the mats, and resold the services to the newspaper. By analogy

[8] 299 N.Y. 443, 87 N.E. 2d 505 (1949).
[9] 213 F. 2d 23 (1955).

the motion picture producer buys the services of his performers, stores them on film, and by successive assignments they come into the hands of the film exhibitor.

The linen service customer is not buying the services which went into producing the linens. If the service is to be exempt from sales tax, the exemption must be given under the theory that it is the laundering service of the distributor which is being purchased. This appears to be the view expressed in the New York City regulations.

The *Times-Herald* decision raises problems of considerable difficulty. It could be argued that anytime one transfers an article which is the product of the special art, skill, or learning of its creator, he is really selling services. The difference between a very valuable painting and a calendar cover is one of artistic quality, not of canvas and paint.

The key to the *Times-Herald* case is that it is an intangible right which is being purchased—the right to reproduce the artist's work. The same is true in the case of the film service, and of the radio transcription service. If such transfers are to be exempted from a sales tax, the exemption should be not on the grounds of a "service" exemption, or of a "custody only" concept. The grounds should be that a transfer under these circumstances of tangible personalty is a mere incident to the purchase and exercise of an intangible right which is the purpose of the transaction.

If transfers incident to a service or the exercise of an intangible right are not to be taxed, there must be a standard to determine such incidence. Regulations under the District of Columbia Code established such a standard for the *Times-Herald* case. Under the regulations a sale is deemed to be an inconsequential element of a service transaction if the price of the tangible personal property is less than 10% of the cost of the service. In jurisdictions where there is no express statutory provision, no such easily applicable statutory standard exists. In *Dun & Bradstreet, Inc.*, the cost of the service with reference books was four times as great as the cost of the service without the books; yet the transfer of the books was deemed to be a nontaxable incident of the service. On the other hand, a photoengraver who sold completed engravings was taxable on the whole contract price, even though the cost of the metal plates transferred was only 2% of the total paid. Georgia, which has the express statutory exception of sales which are inconsequential elements of a service transaction, has ruled that the relative value of the article transferred and the services performed is not a proper measure of what is inconsequential.

Repair services

When a service man repairs tangible personal property for a customer, and in the process adds new material thereto, has a taxable sale occurred? Clearly, title to the new material passes to the customer. The problem of classification for tax purposes is inextricably bound up with the determination of whether the sale of the repair materials to the serviceman is a sale at retail or a sale at wholesale. The premise of the decisions seems to be that the legislature intends to apply the excise tax only once in the chain of transactions which transfer the article from the producer to the consumer. If the repairman-customer transaction is held to be a service transaction with no taxable sale, then the transaction by which the repairman obtained the materials is taxed as a sale at retail. Conversely, if it is ruled that the repairman acquired the materials at wholesale, then the transfer to the customer must be held to be a taxable sale, or the materials will be consumed without ever having been subjected to the excise tax.

Except for this wholesale-retail complication, repair transactions seem to fall generally within the rules applicable to other service-sale transactions. No consistent rule is deductible from the cases arising in differing jurisdictions except that where the repairman makes a separate charge for materials and labor, the transfer of the materials is held to be a taxable sale.

The entire amount of sale need not be taxable; exceptions provide savings

by ARTHUR H. NORTHRUP

WHEN A TAXABLE sale is made, what is the amount upon which the tax rate is imposed? Significantly, all general sales and use taxes are on ad valorem basis. The terminology used to describe the sales-tax base is bewilderingly various: "sales," "gross income" (Indiana and West Virginia), and "gross proceeds." This should not disconcert us, for in many cases the meaning is further defined in and depends upon the particular statute. Uniformity of language might, therefore, be deceptive.

The variety of provisions permitting or requiring addition of the tax to the sales price and prescribing how the tax shall be billed raises the question whether, when two sales taxes are imposed on the same sale, the basis or measure of one sales tax is the price which includes the other sales tax. In states which restrict the sales tax to retail sales, this problem is minimized for most of the manufacturers' taxes or wholesalers' taxes have, at the point of sale to the consumer, lost their identity as tax money and clearly become an integral part of the price. However, the problem arises in connection with Federal retail excise taxes and state motor fuel taxes even in these states.

A tax on a tax is not necessarily unconstitutional, but the invalidity of taxing Federal tax funds is shown by the following argument which was recently successful in preventing Indiana gross income taxation of a producer of gasoline on amounts collected as Federal excise tax:

1. The Federal excise tax on gasoline sold by a producer is a tax upon the sale, not upon the manufacture.

2. It is not a part of his sale price.

3. It is intended to be, and is, a tax upon the purchaser, to be paid and borne by the purchaser.

4. The producer is the collector of the Federal excise tax and is the agent of the United States for the purpose of such collection.

Based upon the foregoing analysis:

5. Amounts collected by the producer and paid over by it are not subject to tax under the provisions of the Indiana Gross Income Tax Act.

6. To subject these amounts to taxation by the State of Indiana would be to tax (a) monies collected and held as taxes of the United States and (b) the collection of such taxes by an agent of the United States violates the constitutional immunity of such revenues and

such agency under the Constitution.

7. To subject these amounts to taxation by the State of Indiana would be to tax gross receipts of the United States as if they were gross receipts of the producer and would, therefore, deprive the producer of its property without due process of law. It should be noted that the logic of the foregoing argument provides no basis for exclusion of the Federal excise tax on gasoline from the price and sales tax base of a sale by a retailer to the consumer. Thus, the double taxation of gross receipts of a liquor dealer under the Illinois Retailers Occupation Tax Act and the Liquor Control Act was held valid in *Bardon v. Nudelman*.[10] In Illinois the retailer's tax itself is part of the tax base. However, the tax is imposed at the rate of 2% on 98% of the sale price. Thus, in effect, the 2% tax is excluded from the tax base.

The sequence of Alabama cases culminating in *Ross Jewelers, Inc.*[11] shows a tendency to include Federal taxes in the state sales tax base if the retailer did so in collecting the tax from the customer. The most recent opinion on the *Ross* case indicates a policy on the part of some courts to exclude Federal excise taxes from the state sales tax base. In Kansas, the ultimate consumer pays the tax; an article is taxed only once.[12] Maine has held that the sales tax is on the consumer.[13] Consumers can therefore deduct it for income tax purposes. Maine in the same case held that the sale of food to employees in a manufacturer's cafeteria is a retail sale.

Shipping and storage costs

An analogous question is whether shipping costs and storage costs should be included in the tax base price. The argument in the foregoing section would apply directly on this point, except for the matters which arise from the statutory construction of the statutes imposing the other taxes and for the problems of governmental immunity. The problem of whether the shipping and storage costs arise before, at the moment of or after the sales tax is, with these exceptions, exactly the same as the problem of double taxation.

Accordingly, it has been uniformly held that when the shipping or storage occurs prior to sale and is a necessary cost of delivering the goods to the purchaser, in accordance with the terms of the sale at a given time and place, such shipping and storage charges are included in the purchase price and in the measure of the sales tax.[14] A separate billing of the customer will not change the general rule if no other facts are changed.[15]

In *Bloxom v. Henneford*,[16] the court reviewed the cost of transportation to the purchaser's place of business. It held that freight, drayage or other costs, paid by the purchaser after he bought the goods, cannot be part of the measure of a sales tax imposed upon "the purchase price." Clearly, the argument of the *Bloxom* case would apply with equal force to storage incurred after the sale upon which the tax is imposed.

When the goods are sold f.o.b. by the purchaser who accepts delivery subject only to inspection upon delivery to the carrier or warehouse, the base of the tax would be the sale price exclusive of storage costs or shipping charges separately billed to the customer. The reasoning here would be the same as under the double-tax situation. It should be noted, however, that whenever the shipment is intended to go outside the state the advantage to the seller is in providing for acceptance of delivery by the purchaser after shipment so that the entire transaction would be subject to an interstate commerce exemption and not fall within the rule of *Wood Preserving Corp.* (313 U.S. 62 (1941)).

Taxing containers

Four situations can be distinguished: the taxation or exemption of *empty* containers when they are (1) nonreturnable and (2) returnable, and the taxation of *filled* containers along with the contents when they are (3) returnable and (4) nonreturnable.

In most instances when the matter has been largely left to judicial interpretation, a sale of a nonreturnable empty container has been held to be a taxable retail sale.

In Ohio, a rule adopted by the tax commissioner pursuant to statutory authority excluded from taxation sales of packing or wrapping materials and containers to be used in packing, wrapping or crating tangible property sold in an established business. Approving this rule, *Kroger Grocery & Baking Co.*[17] held that sales of cartons, containers and wrapping materials to a grocery company for use in connection with the sale of its products were exempt from the retail sales act.

It is somewhat difficult to justify the cases which are contrary to the *Kroger* rule. The price of the container is undoubtedly reflected in the price of the product when it is sold at retail in the container, particularly in states which have stated as one of the goals of their taxation that the product will be taxed only once at its ultimate sale.

Suppose new bottles and cases are purchased by a ginger ale manufacturer for sale, filled, to the ultimate consumer. Title to the bottles and cases passes upon this ultimate sale of the ginger ale. Nevertheless, the bottles and cases may be returned for a refund which the ginger ale manufacturer is obligated to pay. So the ultimate sale of ginger ale is not treated as an ultimate sale of the bottles. It is disregarded for tax purposes, and the first sale of the bottles to the ginger ale manufacturer is taxed as a retail sale. From the point of view of collecting the tax at least once, the result is sound. The tax is not collected a second time because the amount posted by the ultimate consumer of the ginger ale is treated as a deposit to assure return of the container and the sales tax does not apply to the deposit. The difference is that the state now derives revenue from bottles returned by the consumer and discarded by the ginger ale manufacturer as unfit for use. Presumably, the deposit is not taxable even though the bottles are never returned by the consumer, or their return is refused (because "unfit" or for no reason), since the tax has been paid on the bottles. In such an event, the deposit could cover the cost of the bottles and cases, including the tax.

Returnable containers

A returnable soft-drink bottle is a container; its purchase by retailer from manufacturer is not a retail sale and is not taxable.[18]

Sales of milk bottles to retail distributors of milk when bottles are returnable by consumers to distributors are not retail sales subject to tax, under the containers exemption.[19]

Oil drums returnable to a seller by the consumer do not come within the

[10] 369 Ill. 214, 15 N.E. 2d 836 (1938).
[11] 260 Ala. 682, 72 So. 2d 402 (1954).
[12] Southwestern Bell Tel. Co. v. State Comm'n, 168 Kan. 227, 212 P. 2d 363 (1949).
[13] W. S. Libbey Co. v. Johnson, 148 Me. 410, 94 A. 2d 907 (1953).
[14] For a discussion of the older cases on deductibility of freight charges in determining gross receipts see Annot., 102 A.L.R. 768 (1936).
[15] Gee Coal Co. v. Department of Finance, 361 Ill. 293, 197 N.E. 871 (1935); State v. Menefee Motor Co., 18 La. App. 694, 139 So. 61 (1932); State *ex rel.* Snidow v. State Bd. of Equalization, 93 Mont. 19, 17 P. 2d 68 (1933); Hope Natural Gas Co. v .Hall, 102 W. Va. 272, 135 S.E. 582 (1926).
[16] 193 Wash. 540, 76 P. 2d 586 (1938).

exemption of sales of containers to manufacturers.[20] This is a special statutory problem.

Rhode Island taxes sales (not resales) of empty, returnable containers or filled non-returnable containers. Thus the sale of the container is taxed only once.

In *Inchausti & Co.*[21] the parties admitted that it was customary to sell hemp in the market baled and not loose. The court held that the cost of bailing should be included as part of the purchase price in computation of the sales tax. *Potter*[22] held that a tax of five cents to be paid on containers of malt syrup or malt extract should be computed by weighing the entire contents of the containers filled with liquid ingredients.

When gasoline was sold from a tank containing 30% taxable and 70% nontaxable gasoline, each sale should be taxed at 30% of the whole amount sold rather than wholly exempting sales which accounted for 70% of the tank's contents.[23]

Returns, discounts and allowances

Provisions for returns, discounts and allowances are almost entirely statutory. In many cases, however, clear provisions in the statutes are lacking. Only in North Carolina and West Virginia does the statute clearly prohibit the deduction of cash discounts allowed at the time of sale and later taken. Many statutes put time limitations on the provision for returns. Rhode Island requires the return within 120 days, and California within 90 days, for example. Nearly all statutes permit the exemption of sales when the item is returned, regardless of whether repayment of the purchase price is made in cash or credit.

Credit sales and bad debts

Some statutes distinguish between conditional sales contracts which provide for installment sales and ordinary credit. When such a distinction is made, there are usually statutory provisions for obtaining the approval of the office administering the tax for paying the tax on conditional sales as the amounts are received. Some states permit all credit sales to be treated in this manner, either at the taxpayer's option or subject to the prior approval of the office administering the tax. If the credit sale is treated as completely taxable at the time it is entered into, three additional problems arise: (1) if the debt turns out to be bad, may a tax credit based on an unpaid balance be allowed? (2) if the sale was subject to a mortgage or otherwise involves a mortgage, does the tax base include the full amount of the mortgage? and (3) are interest and service charges included in the sale price for purposes of tax computation?

The North Carolina statute permits merchants to obtain an extension of the time of payment of tax on credit sales. They may then include in each monthly tax report the installments collected during the previous month and pay the tax only on amounts actually collected. Otherwise, the merchant may pay the tax when the sale takes place and take credit for the amount of the tax when the bad debt is charged off for income tax purposes.

In the absence of specific statutory provision for credit sales, *Gardner-White Co.*[24] held that the tax became due when the sales contract was accepted by both the buyer and the seller. The taxpayer was not permitted to compute the tax as and when each installment payment was actually made, nor to take any deduction for bad debts or credit losses.

Similarly, *Rudolph Wurlitzer Co.*[25] held that there was no right to refund or credit on the tax upon repossession of property sold on conditional sales contract for nonpayment of installments. The court held inapplicable the statutory provisions permitting deductions of credits or refunds for returned goods. A leading Federal case permits no tax credit for bad debts. That is *Slavick Jewelry Co.*,[26] which applied the 5% jewelry tax on the gross contract sales price even though an unpaid balance had been charged off and the account closed.

The statutory provisions in Alabama, that in all events there is no tax until collection, or in Georgia, that the taxpayer may elect to pay the tax on an accrual basis, seem much more equitable. So do the provisions of the North Carolina statute which make the tax the debt of the purchaser, payable as the price is collected, or which permit a credit to be taken for the tax when the debt is charged off. Similarly, the North Dakota statute allows a credit for the tax paid at the time the account is charged off with a specific statutory provision that any subsequent collections on the account are taxed.

An equally significant question is whether the interest or service charge on a credit sale is part of the taxable sales price. A few statutes specifically exclude service charges; a few specifically include them. Most statutes are not clear on this point. In *Bachrach Motor Co.*,[27] an installment sale of an automobile, title passing at the time of the sale, was held to be taxable only on the sales price "or value of the things in question at the time they are disposed of" without including interest on installments, even though predetermined.

Taxation of rental receipts

Most states provide in broad terms for the taxation of rents under which the lessee retains possession of personal property. However, these provisions are usually intended to cover lease arrangements which are in fact disguised conditional-sales contracts. Regulation 60 under the Nevada sales tax act provides that a sale disguised as a lease is taxable as a sale if, for example, the property is substantially consumed during the life of the lease. Again the variety of statutes is significant, particularly the tendency to distinguish between taxable hotel facilities and short-term leases and nontaxable long-term leases. Most statutes, of course, are confined to tangible personal property. Thus, the rental of ice skates at a skating rink was held taxable in *Pla Mor, Inc.*[28] Many statutes provide that the rental of an article is taxable if the sale of the article would be. Other statutes, such as those in North Carolina, Rhode Island and Pennsylvania, do not tax rents unless the transaction is actually a sale.

Supreme Distributors, Inc.[29] held that income from juke boxes and coin devices is rental in the amount received by the box owner, not joint income on total receipts by the location operator and the machine owner. In Florida, music might also be an amusement for purposes of taxation.

The Colorado statute provides for taxation if the right to continuous possession or use is granted under a lease of an article which would be taxable if sold. Accordingly, the renting of automobiles to the public for temporary

[17] 149 Ohio St. 120, 77 N.E. 2d 921 (1948).
[18] Coca-Cola Bottling Plants v. Johnson, 147 Me. 327, 87 A. 2d 667 (1952).
[19] Evans v. Memphis Dairy Exchange, 194 Tenn. 317, 250 S.W. 2d 547 (1952).
[20] Consumers Cooperative Ass'n v. State Comm'n, 174 Kan. 461, 256 P. 2d 850 (1953).
[21] 20 Phil. 345 (1911).
[22] 252 Mich. 460, 233 N.W. 380 (1930).
[23] Charleston Oil Co. v. Carter, 131 S.C. 468, 128 S.E. 8 (1925).
[24] 296 Mich. 225, 295 N.W. 624 (1941).
[25] 281 Mich. 558, 275 N.W. 248 (1937).
[26] 26 F. 2d 571 (9th Cir. 1928).
[27] 53 Phil. 999 (1929).
[28] 149 Ohio St. 295, 78 N.E. 2d 725 (1948).
[29] 54 So. 2d 805 (Fla., 1951).

use upon the basis of charges for time, mileage, service, oil and gas, and damages has been held not taxable.[30] The same case held that sales of automobiles to a business renting them out were not wholesale sales even though wholesale prices were paid. To like effect, on the exemption of automobile rentals from sales tax, is *U-Drive-'Em Service Co.*[31]

Likewise, when a photographer furnished photographic prints and manual illustrations to customers for reproduction by them for advertising purposes and the photographer or illustrator retained title, the New York City sales tax did not apply.[32]

On the other hand, a transaction under which a typesetter produced finished work for a printing house, billing an extra charge as a deposit to ensure the return of the type, was held subject to sales tax.[33] Similarly, use of motion picture films to an exhibitor was held to be a taxable sale in *United Artists Corp.*[34]

Taxation of exchanges

There are a variety of statutory provisions. Many provide that the taxes be imposed upon receipts in money or goods valued in money and stop there. The obvious difficulty with the ordinary provision for taxing exchanges at the full value allowed by the retailer is that the retailer, when he sells the goods traded in, will be subject to a second sales tax unless the statute specifically exempts sales of merchandise which was traded in, as many do.

Hartman Bros.[35] held that an automobile dealer could be taxed on the full retail price, that he could get no allowance for trade-ins and that he could be taxed again when the automobile traded in on the first sale was sold. The undesirability of this 1939 decision had a salutary effect, for the 1941 amendments to the Colorado act provide fair alternatives to the retailer in handling goods received in exchange and resold which might well be copied in other states.

In some cases where the transaction is not at all for cash, the tax has been held inapplicable. Food served free to employees was not taxable in *Southwest Hotels.*[36]

Many statutes provide for reduction from the price base of the original sale of the full amount allowed for the trade-in. Others provide for nontaxability at the time of resale.

More statutory clarification is needed. A trade-in received by one in the business of selling the article should not, to that extent, be a retail sale or a realization of value at the full retail rate.

Do retail sales include services?

Local services do not confer jurisdiction to tax. Thus, advertising in Maryland, delivery of goods to common carriers consigned to Maryland users, and delivery in its own trucks in Maryland was not a basis for imposing a duty of collecting Maryland use taxes on a Delaware corporation through seizing its delivery truck. The Maryland statute violated the due process clause of the Fourteenth Amendment, since no mail or telephone orders were accepted and no personal solicitation was done in Maryland.[37] Nor, said the Supreme Court, could a sales tax apply to a Delaware vendor.[38]

Hopkins[39] held that, even though the value of tangible materials employed in the manufacture of eyeglasses is only 20% of the total price charged the consumer, the sales tax on tangible personal property applies to the whole amount.

Serving food and drink is a sale, though common law said it was a service.[40] Similarly, restaurants are taxed as making retail sales under the Ohio act.

Feed purchased in connection with shipments by a common carrier was not exempt as a wholesale sale, or as a service connected with transportation, or as interstate commerce.[41] Sale of leather products and shoe findings to repairmen for use in repairing shoes is a taxable retail sale and not a sale for resale.[42]

Because of the characteristics noted in the *Hopkins* case, sales of eyeglasses by optometrists, oculists and ophthalmologists have been a fertile field for sales tax litigation. Most courts follow the *Hopkins* decision, even though the glasses are supplied by an oculist or optometrist pursuant to a prescription which he made himself after examining the eyes.[43]

A sale by a repairman is taxable in the full amount if service is not segregated.[44] *Western Leather*[45] may be impliedly overruled by *Utah Concrete Products Corp.*[46] *Merriwether*[47] held that sales of automobile parts and supplies to a retail automobile dealer for use in reconditioning used automobiles for sale was subject to the retail sales tax, since the used-car dealer is not a manufacturer. This was in accordance with *Cody,*[48] wherein sales made to automobile repair shops were held taxable. *Doby*[49] shows that Alabama's position is consistent, since an automobile repair shop was held not liable for sales tax on the gross proceeds of sales of parts and accessories used in reconditioning second-hand automobiles. The Alabama statute exempts the sale of used automobiles and the court refused to require segregation of parts.

Segregation of sales from services

Warshawsky & Co.[50] likewise refused to permit segregation of new and used automobile parts, but in this case the entire sale price of the reconditioned motor was held to be subject to the tax. This is consistent with the usual Illinois view that the tax either applies to the gross receipts of the occupation from sales or it does not. Accordingly, Illinois does not allow transactions to be segregated for tax purposes.

Recapping or retreading of tires has been another field of litigation on whether services or retail sales are involved.

Hawley v. Johnson[51] held that even though the sales price of exchanges should be "valued in money,"[52] the agreed trade-in price governs the amount of the gross receipts from sale rather than the full value of the merchandise accepted in trade, because the

[30] Herbertson v. Cruse, 115 Colo. 274, 170 P. 2d 531, 172 A.L.R. 1312 (1946).
[31] 205 Ark. 501, 169 S.W. 2d 584 (1943).
[32] Howitt v. Street & Smith Publications, 276 N.Y. 345, 12 N.E. 2d 435 (1938); Andersen, 172 Misc. 370, 15 N.Y.S. 2d 15 (Sup. Ct. 1939).
[33] Typekrafters, Inc., 34 Pa. D. & C. 82 (1938).
[34] 273 N.Y. 334, 7 N.E. 2d 254 (1937).
[35] 104 Colo. 190, 89 P. 2d 584 (1939).
[36] 213 Ark. 140, 209 S.W. 2d 469 (1948).
[37] Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954), *reversing* 201 Md. 535, 95 A. 2d 286
[38] 347 U. S. at 346.
[39] 234 Al. 556, 176 So. 210 (1937).
[40] Pappanastos v. State Tax Comm'n, 235 Ala. 50, 177 So. 158 (1937).
[41] Utah Concrete Products Corp. v. State Tax Comm'n, 101 Utah 513, 125 P. 2d 408 (1942).
[42] W. J. Sandberg Co. v. Iowa, 225 Iowa 103, 278 N.W. 643, *modified on rehearing*, 281 N.W. 197 (1938); Craig-Tourial Leather Co. v. Reynolds, 87 Ga. App. 360, 73 S.E. 2d 749 (1952).
[43] Kamp v. Johnson, 15 Cal. 2d 187, 99 P. 2d 274 (1940); Rice v. Evatt, 144 Ohio St. 483, 59 N.E. 2d 927 (1945); Pennsylvania v. Miller, 337 Pa. 247, 11 A. 2d 141 (1940).
[44] Western Leather & Finding Co. v. State Tax Comm'n, 87 Utah 227, 48 P. 2d 526 (1935).
[45] *Ibid.*
[46] See note 42 *supra.*
[47] 252 Ala. 590, 42, 465, 11 A.L.R. 2d 918 (1949).
[48] 235 Ala. 47, 177 So. 146 (1937).
[49] 234 Ala. 150, 174 So. 233 (1937).
[50] 377 Ill. 165, 36 N.E. 2d 233 (1941).
[51] 58 Calif. App 638 (1943).
[52] See Eisenberg's White House, Inc. v. State Bd., 72 Calif. App. 2d 8, 164 P. 2d 57 (1947).
[53] 377 Ill. 331, 36 N.E. 2d 550 (1941).
[54] 373 Ill. 381, 26 N.E. 2d 483 (1940).
[55] 272 N.Y. 275, 5 N.E. 2d 818 (1936).
[56] 38 F. Supp. 319 (S.D.N.Y. 1951).
[57] State *ex rel.* Otis Elevator Co. v. Smith, 357 Mo. 1055, 212 S.W. 2d 580 (1948).
[58] 333 Pa. 46, 3 A. 2d 412 (1939).

California statute excludes cash discounts from gross receipts.

Consistent with the Illinois occupational approach, *Mahon v. Nudelman*[53] held that restyling and repairing fur garments for customers is a repair business and the incidental transfer of title to added furs and linings was not a retail sale. However, in *C .& E. Marshall Co.*,[54] the court held that sales of crystals, clock glasses, pinions, springs and other jewelers' supplies to retailers who assembled and repaired watches were not retail sales since, with minor alterations the parts entered the customer's watch in the same form in which they were purchased and ultimate consumers were billed separately for the retail labor and services.

On the contrary, *Mendozo Fur Dying Works*[55] held that the sale of dyestuffs to a dyer was a taxable retail sale, since the dyer was not primarily in the business of reselling dyestuffs but in the business of rendering skilled services in performing the labor of dyeing. To like effect, is *In re H. D. Kampf, Inc.*,[56] although this case was based on the ground that a sale of dyes and chemicals was a retail sale because it was a sale for consumption.

Several cases hold that transactions involving services are rentals and not sales, or sales of real estate or otherwise distinguishable from retail sales of personal property.

When small parts were sold on oral contracts in connection with elevator repairs, the elevator company was not liable for tax since the parts became a part of the realty.[57] Rejecting a similar contention, *Pennsylvania Heat & Power Co.*[58] imposed the tax on the sale of installed oil burners and their parts and accessories.

The construction and installation cases are somewhat analogous. *Material Service Corp.*[59] holds that neither the materialman who sells to the contractor nor the contractor who installs materials into a building which is sold is making taxable retail sales of the materials.

In *Imperial County*,[60] sales of crushed rock and gravel at cost by a county to a city for roadwork were held to be taxable. The county had contended that it was not engaged in the business of making sales at retail.

A materialman's sales to contractors are taxable retail sales.[61] A retail sales tax has been imposed upon the transaction between the contractor and the landowner or subcontractor.[62]

Although a laundry performed a service exempt from the Tennessee sales tax, the tax applied to the full rental on laundered diapers.[63]

In some states, services are taxable as such, whether or not sales are involved. When services are excluded, what price is used as a sales price? Is it wholesale or retail? A manufacturer who sells cement blocks at retail and who also constructs cement block foundations is liable, when he does construction, only for a tax based on the cost to him of the materials or articles consumed by him in manufacturing the blocks. He is not liable for the tax on the full retail sale price of his own blocks used by himself in construction.[64]

On the other hand, funeral directors are reasonably taxed twice on the cost of the casket to them unless they segregate the fair selling price of the casket from the total cost of the funeral.[65]

If services are not segregated, the entire sales price of an optometrist for eyeglasses is taxable.[66]

If the price of monuments erected at a grave includes the price of labor to erect the monument, the owner of the monument must pay the tax on the total sales price, without deducting the cost of labor.[67]

In connection with the cases on segregation of taxable amounts, it should be noted that in general the burden of proof as to the amount for which the taxpayer is liable under a sales tax is upon the taxpayer.[68]

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Does occupation or transaction control?

The cases requiring segregation of retail sales from services to avoid taxation of the whole charge are an interesting contrast to the Illinois principle that the occupation is either wholly taxable or not taxable at all. This problem, which arises particularly in connection with retail sales mixed with services, also arises in connection with distinctions between retail sales and wholesale sales. For example, *Herbertson v. Cruse*[69] held that since a public automobile-renting business did not involve a sale of the automobile, the purchase of automobiles for use in such a business was a taxable retail sale, even though wholesale prices were paid. To the same effect, *J. P. Michael Co.*[70] held that sales to hospitals and other institutions by a wholesale grocer at wholesale prices were sales to the ultimate consumer and not sales for resale. This case applied the tax at retail rates.

An evolution in the philosophy of taxation is visible in the Indiana cases The *Michael* decision is consistent with all the early Indiana cases and with the language of the Indiana gross income tax act that the individual transaction, and not the occupation of the seller, determines whether wholesale, retail, or general income rates of tax are applied. Accordingly, all of the early Indiana cases involving the sale and service problem required segregation, with taxation of all unsegregated proceeds at the highest rate applicable to any of them. Then the department of revenue succeeded in *Samper*[71] in obtaining a decision that the general income rate of 1% applied to the receipts of a radio and television repair shop, even though the taxpayer had segregated and reported at the one-half of 1% retail rate his receipts from parts installed in cabinets owned by customers and other repair parts. The *Samper* case allowed the retail rate only upon sale of complete radio and television sets and over-the-counter sale of parts. The *Samper* case cited as its authority a construction case, *Fort Pitt Bridge Works*,[72] which taxed all the re-

[53] 380 Ill. 226, 43 N.E. 2d 939 (1942).
[54] 76 Calif. App. 2d 572, 173 P. 2d 352 (1946).
[55] Craftsman Painters & Decorators v. Carpenter, 111 Colo. 1, 137 P. 2d 414 (1942); State v. Christhilf, 170 Md. 586, 185 Atl. 456 (1936); Woodrich v. St. Catherine Gravel Co., 188 Miss. 417, 195 So. 307, 127 A.L.R. 1179 (1940); St. Louis v. Smith, 342 Mo. 317, 114 S.W. 2d 1017 (1937); Albuquerque Lumber Co. v. Bureau of Revenue, 42 N.M. 58, 75 P. 2d 334 (1937); Atlas Supply Co., 212 N.C. 624, 194 S.E. 117 (1937).
[56] Wiseman v. Gillioz, 192 Ark. 950, 96 S.W. 2d 459 (1936); Metzen v. Department of Revenue, 310 Mich. 622, 17 N.W. 2d 860 (1945); R. C. Mahon Co. v. Department of Revenue, 306 Mich. 660, 11 N.W. 2d 280 (1943), *overruling* Metzen v. Brown, 301 Mich. 532, 3 N.W. 2d 870 (1942); Kohn v. Philadelphia, 151 Pa. Super. 635, 30 A. 2d 672 (1943).
[57] Saverio v. Carson, 186 Tenn. 166, 208 S.W. 2d 1018 (1948).
[58] 1941 Ohio B.T.A. 954.
[59] Kistner v. Iowa State Bd. of Assessment and Review, 225 Iowa 404, 280 N.W. 587 (1938).
[60] Rice, 144 Ohio St. 483, 59 N.E. 2d 927 (1945).
[61] Ferguson v. Cook, 215 Ark. 373, 220 S.W. 2d 808 (1949).
[62] Pierce Oil Corp. v. Hopkins, 264 U.S. 137 (1924); Carrol v. Tuskaloosa, 12 Ala. 173 (1847); Standard Oil Co. v. Brodie, 153 Ark. 114, 239 S.W. 753 (1922); Miller v. People, 76 Colo. 157, 230 Pac. 603 (1924); Board of Administrators v. Girardey, 36 La. Ann. 605 (1884); State v. Girardey, 34 La. Ann. 620 (1882); Commonwealth v. Thorne, Neale & Co., 264 Pa. 408, 107 Atl. 814 (1919); *In re* Mercantile License Tax, 77 Pa. Super. 93 (1921); Comonwealth v. Atlantic Ref. Co. 69 Pa. Super. 32 (1918); Commonwealth v. Banker Bros. Co., 38 Pa. Super. 101 (1909), *aff'd*, 222 U.S. 210 (1911); Annot., 39 A.L.R. 273 (1925).
[63] 115 Colo. 275, 170 P. 2d 531, 172 A.L.R. 1312 (1946).
[64] 105 Ind. App. 255, 11 N.E. 2d 512 (1937).
[65] 231 Ind. 26, 106 N.E. 2d 797 (1952).
[66] 227 Ind. 538, 86 N.E. 2d 685 (1949).

ceipts from the performance of a construction contract at the 1% rate, even though materials were installed in connection with the construction, on the basis that the contract was indivisible.

Retailers were not long in seeing the significance of the *Samper* holding that an indivisible contract must be taxed entirely at the rate which depended upon the predominant nature of the transaction. If, for example, delivery and installation were incidental to a retail sale, that should be taxed at the retail sales rate of one-half of 1% and not segregated at 1% as services. The Indiana Supreme Court so held in *L. S. Ayres & Co.*[73]

Indiana has thus moved very far away from its rule requiring segregation and is approaching the position of the Illinois Retailers Occupation Act. In Illinois, salts which are incidental to other business activity are not taxable.[74] The Illinois cases hold that the tax is on the seller's occupation and not upon the sale or the consumer.

In general, the legal form or commercial device involved in a sale usually has no effect upon the computation of sales tax liability. It seems to make no difference whether the retailer owns the goods or services sold. Alabama taxes sales by a retailer, although the property was held on consignment.

Connecticut has ruled that tire recappers are retailers whether the customer furnishes the tire casing or not. They are taxable on the charges made.

Tips received by waitresses are taxable gross receipts of the employer if agreed that they belonged to the employer and could be credited against minimum wages.

In states which require the collection of the retail sales tax from the customer where the sale is by vending machine, some difficulty in collecting has been encountered.

Until the 1951 amendments, sales by coin-operated vending machines were not included in taxable retail sales. The problem involved is that the tax is on the customer and there is no one to collect it. Maryland permits sellers to pay tax on vending-machine sales.

Such sales may not fit the statutory definition of retail sales. *Castleberry v. Evatt*[75] held that sales of packaged fluid milk by a dairy through vending machines located in an industrial plant over which the vendor exercised no control except the right of ingress and egress to service machines were sales off the "premises where sold." They were not taxable.

Conclusion

Double taxation can result when: a tax includes the amounts of other taxes; two or more taxes exist on the same occupation or transaction; there is a tax on the retail sale of component parts, such as shipping and storage containers, as well as the final sale; the same article taxed twice because goods which have been returned or exchanged are resold; and repairs (including replacement parts, as well as the sale of parts to repairmen, are taxed. Much of the difficulty arises in the definition of a retail sale, but attempts to tax only the final transaction and frankly to recognize that the tax is on the consumer at least give a guide to courts. More diverse taxes typically encounter the same problems in connection with rate distinctions and lack this guide.

While some states have made careful efforts in their sales and use taxes to fit a pattern left by their other taxes and the taxes of other states and the United States, most states impose a sales tax without sufficient regard for existing excises on motor fuels, liquors, cigarettes and other special areas and without regard to license fees on certain businesses which may also be measured by gross receipts.

Another area of weakness in most state sales taxes is in the treatment of credit sales. Most statutes do not indicate whether service charges or interest are part of the measure or base of the tax. Many provide for obtaining approval of the administrative agency for paying the tax on credit sales as collections are made. The measure or base of a sales tax is as significant as the assessed valuation in property taxation or the cost base in capital gains taxation or the definition of net income in income taxation. To clarify the measure of sales taxes, courts and administrative officers have filled some of the many gaps left by statutes.

Determining whether exemptions apply is still difficult; courts unsure

by **GEORGE D. BRABSON**

GENERALLY SPEAKING, there are three broad areas of exemption under statutes imposing sales and use taxes in the United States. These are: (a) exemptions arising out of the immunities of governmental agencies and instrumentalities, or out of the exercise of governmental functions; (b) exemptions arising under the commerce clause of the Federal Constitution; and (c) specific exemptions created out of governmental taxing policies or social economic considerations.

Governmental immunities and functions

It is a little surprising to note that until as late as 1939 the great preponderance of governmental activities, both Federal and state, was deemed to be exempt from sales or use taxes. Every acre of Federal land or of occupation was looked upon as a sort of oasis in which no state taxes could be imposed upon the sales or other business activities carried on there. As late as 1940 it was held that a state had no authority to collect a use or privilege tax on gasoline sold on a Federal reservation. There can be no question but that this was the general rule until passage of the Hayden-Cartwright Act by Congress in 1936, and that the rule was applicable to sales, use, storage and other types of license taxes.

A simple example of this type of governmental exemption should be sufficient to illustrate the inequitable consequences both as between the taxing state and a neighboring state. In most western states, Federal land holdings are extensive and in some places exceed the areas privately owned. Because some Federal reservations occupy up to the center line of a city street, Federally licensed traders could sell free of any taxes on one side of the street, while private merchants across the street were subject to such sales, use and license taxes as the state chose to levy. A mile or so away, across a state line, no such taxes were imposed. Thus the taxing

[73] 233 Ind. 194, 118 N.E. 2d 480 (1954).
[74] Svithiod Singing Club v. McKibbin, 331 Ill. 194, 44 N.E. 2d 904 (1942); Mahon v. Nudelman, 377 Ill. 331, 36 N.E. 2d 550 (1941); Herlihy Mid-Continent Co. v. Nudelman, 367 Ill. 600, 12 N.E. 2d 638, 115 A.L.R. 485 (1937).
[75] 147 Ohio St. 30, 67 N.E. 2d 861, 167 A.L.R. 198 (1946).

jurisdiction found itself competing for revenue against both tax-free jurisdictions, and the merchants in the taxing state were competing against tax-free sales.

The Hayden-Cartwright Act provided in substance that all taxes levied by any state upon sales of gasoline and other motor fuels could be levied in the same manner and to the same extent upon such fuels sold in any Federal territory or area, except when sold to or for the exclusive use of the Federal Government.

Congress passed in December 1940 what was in effect an amendment to the Hayden-Cartwright Act. This new act, generally referred to as the Buck Act, provided in substance that all kinds and types of businesses carried on in whole or in part in Federal territories or areas located within a state or states would be subject to the same sales, use, license, income and other taxes of general application imposed by such state or states upon similar transactions in such state or states.

It was soon apparent that the Hayden-Cartwright Act was not a panacea for all the conflicts arising from Governmental immunities. As late as 1928, the Supreme Court had held in *Panhandle Oil Co.*[76] that a state was without authority to levy any kind of tax on sales made to the Federal Government. In the *Indian Mortorcycle Co.* case,[77] decided shortly thereafter, the Court held that a Federal excise tax could not be levied on motorcycles purchased by a state or one of its political subdivisions, if done in the exercise of a governmental function of the state, and not in its proprietary capacity.

Notwithstanding these decisions, certain of the states insisted upon the application of their sales and use taxes to transactions entered into within their boundaries by such Federal agencies as national banks. In 1934 the Supreme Court ruled against this practice. It held in *Standard Oil Co.*[78] that retail sales taking place in a post exchange on the Presidio constituted sales by an agency of the Federal Government and were not subject to the California license tax. As a result of this decision, as well as the strong opposition from Federal purchasing agencies to such levies, the State of California amended its act so that virtually all sales to the Federal Government were exempted from the California tax.

Other states, such as Ohio, Michigan, Pennsylvania and Wisconsin, also took action. Either by act of the legislatures or through administrative regulations, they exempted gasoline and motor fuels from sales tax if they were sold to a Federal agency or to a contractor working for the Federal Government. Up to 1940, in addition to these specific exemptions as to motor fuels, at least 15 states had granted a general exemption from sales tax on all materials and supplies sold to Federal Government contractors, or used by them in carrying out Government contracts.

In the various decisions coming out of the state and Federal courts, some very fine lines of distinction were drawn. Some courts stressed that unless the agency involved were exercising a strictly governmental function no exemption from tax would be allowed. Other courts held that sales taxes might be imposed upon independent contractors performing services for the United States, but not upon cost-plus contractors, who were presumably acting as agencies of the Federal Government. Still others held that to exempt from sales taxes contractors dealing with the Federal Government would cause unconscionable burdens upon the states and hence should not be allowed.

Some of the confusion arising from this line of cases was dispelled by the decision of Supreme Court in the now ubiquitously cited *King & Boozer* case.[79] In that case Alabama sought to impose its retail sales tax on King & Boozer, lumber merchants in Alabama supplying lumber on order of the contractor who was building, on a cost-plus basis, army camp buildings in that state. Two arguments were advanced by Federal attorneys opposing the tax: first, that the contractor was working under a cost-plus contract and hence was in legal effect an agency of the Federal Government; and second, that the economic burden of the tax was in effect imposed upon the Government, which should not have its governmental operations curtailed by increases in costs.

The Supreme Court rejected both arguments. Regardless of the precise nature of the contract, the contractors were obligated to pay the tax as part of the total cost of the lumber. Hence, the contractors, not the Government, were the actual purchasers. This obligation to pay the tax, said the court, was not relieved merely because they were acting in a loose sense on behalf of the Government. Nor were they relieved of the obligation merely because the economic burden of the tax could be shifted by them to the Government as the ultimate consumer. The contractors did not take on the character as agents of the Federal Government either to enter into contracts or pledge its credit. The tax was not a levy on the Federal Government; hence the contractors could invoke no governmental immunity.

The rationale of the *King & Boozer* case was as effective in the state legislatures and administrative agencies as it was in the courts. It was broad enough in its language so that it virtually eliminated the wide exemptions, based on the theory of implied agency, which had theretofore been accepted by the states. As a consequence, several state legislatures amended their sales-tax acts to eliminate the broad exemptions covering sales to contractors and other persons dealing with or on behalf of the Federal Government. Other states modified their administrative rules to eliminate the exemption in all but special cases, as when the contractor is specifically authorized to act on behalf of a Federal purchasing agency.

Recent Federal decisions

A review of the more recent decisions of the Federal courts dealing with Governmental immunities to sales taxes and similar license and excise taxes indicates that these courts are still somewhat uncertain about the application of *Dravo Contracting Co.*[80] and the *King & Boozer* case. On the one hand, the Supreme Court said in *Roane-Anderson Co.*[81] decided in 1952, that Tennessee could not impose sales and use taxes on materials purchased and used by private contractors in performing contracts for the Atomic Energy Commission, since the Atomic Energy Act gives an express exemption from state and local taxation. Again, in *Federal Land Bank v. Bismarck Lumber Co.*,[82] it was held that the broad exemption from taxation given by Congress to Federal land banks would avoid the imposition of a North Dakota sales tax levied on sales of lumber for repair of its bank properties in that state. On the other hand, in *Black Hawk Consolidated Mines Co.*[83] the court held that a corporation engaged in selling gold and silver to the

[76] 277 U.S. 218 (1928).
[77] Indian Motorcycle Co., 283 U.S. 570 (1931).
[78] 291 U.S. 242 (1934).
[79] Alabama v. King & Boozer, 314 U.S. 1 (1941).
[80] 302 U.S. 134 (1937).
[81] 342 U.S. 232 (1952).
[82] 314 U.S. 95 (1941).
[83] 52 N.M. 74, 191 P. 2d 996 (1948).

United States Government is not acting as an agency of the Government in making such sales and is subject to the New Mexico gross sales tax.

Taxing officials in most states which impose sales and license taxes are obviously uncertain about the application of these rulings to Federal transactions. In South Dakota, the Attorney General ruled that sales of tangible property to the Production Credit Corporations organized under the Federal enabling act, are not to a governmental agency, but to entities distinct from the Federal Government, and hence subject to sales tax in that state. On the other hand, the same office had ruled earlier that a soil conservation district was a governmental subdivision, and hence sales of materials and gasoline used by the district officials were not subject to sales taxes.

From the foregoing analysis, it becomes apparent that there has been at least a modicum of homogeneity in state and Federal court decisions involving this type of exemption. There are perhaps two reasons for this. In the first place, the decided cases in the majority of instances have arisen in regard to a narrow and confined area of law, to-wit, the power of one sovereign state to lay a tax upon the sovereign functions of another state. In the second place, the legislatures in the various states have over the years and from time to time expressly recognized the principle of Governmental immunity by the enactment of specific provisions granting the exemption in more or less uniform statutory language. This is particularly true of the sales and use tax statutes which have been enacted by the various states in the last 25 years.

As a result, we find that the courts have not differed radically in their construction of the almost uniform wording found in the statutes. We find likewise that the many divergences among the decisions dealing with particular items can be attributed largely to the factual situations, rather than to wide differences in the legal concepts of immunity and exemption from tax. In short, there has been very little variation in the decisions in the various states as to the meaning of the statutory language itself or as to the principles of law involved.

Exemptions under the commerce clause

It goes without saying that the most prolific source of exemptions from sales and use taxes lies in the field of interstate commerce. That this should be so is natural. The Constitutional limitations against burdening or interfering with the flow of commerce between the states have been with us since the beginning, and have always occasioned controversy. This type of controversy began early, and even in the earliest cases a distinction was made between taxes which imposed a direct burden on interstate commerce or which discriminated against interstate commerce, and those which could be said merely to affect such commerce.

Until the depression of the 1930's, the provisions of the commerce clause had always been strictly construed; almost invariably the courts had favored the preservation of the strongly federalist doctrines established by Justice Marshall. Not until the courts began to feel the economic and social pressures of the depression-conscious state legislatures did a more liberal construction of the commerce clause appear.

Of course, not all forms of taxation constitute control or regulation over interstate commerce. The courts have said that "even interstate commerce must pay its way," and the bare fact that a person is engaged in such commerce does not relieve him of all taxes simply because they add to the cost of doing business.

State taxes on gas

Nevertheless the first important departures from the strict rules of the John Marshall school occurred in 1932 and 1934. In two cases, each involving state taxes imposed upon the sale and storage of gasoline, the Supreme Court held that gasoline imported from other states for use in supplying interstate carriers was subject to a sales tax or license tax which applied equally to all users of gasoline and did not discriminate against interstate commerce.

The next step in the development of this new doctrine was to hold that after property transported in interstate commerce has become part of the common mass of property within a state it may be subjected to a tax by that state imposed upon the use or consumption of such property.

Shortly thereafter, the Supreme Court of Alabama broadened the doctrine again in the case of *Graybar Electric Co.*[84] In that case, Alabama imposed on local retail dealers a license tax measured by gross receipts of the dealer from sales. An Alabama dealer took an order from a local customer for certain articles to be shipped f.o.b. from the Ohio manufacturer directly to the Alabama customer. The court held that the amount of such sales was includible in the gross receipts of the dealer and subject to the tax, even though the tax increased the cost of doing business. When the case was appealed to the United States Supreme Court, it was affirmed without opinion.

Meanwhile, the Supreme Court had rendered another decision which, although it dealt with a privilege tax, opened the door to a further extension of the new doctrine. New Mexico had imposed on magazine publishers in that state a license tax measured by the gross sales of advertising space. The Court held the tax was valid even though the magazines were mailed and distributed in interstate commerce. The Court reasoned that the preparation, printing and publishing constituted a local business activity, distinct from its circulation in commerce, and that the burden on such commerce was too remote to call for a rigid application of the rule prohibiting the use of gross receipts from interstate commerce as the measure of a tax.

The Supreme Court had now laid the groundwork for an even further extension of the doctrine permitting the taxation by the states of property actually flowing in the channels of interstate commerce. The opportunity to make such a decision appeared in the well-known case of *Berwind-White Coal Mining Co.*[85] In that case, the City of New York imposed its sales tax on coal mined in Pennsylvania and sold by the mining company through its offices in New York City through salesmen and telephone contacts working in such offices. The Supreme Court held *inter alia*:

1. A sales tax levied on every purchaser of merchandise in a state, regardless of the source of the merchandise, does not violate the commerce clause merely because the merchandise has moved in interstate commerce immediately before transfer of possession to the purchaser.

2. A sales tax conditioned on delivery of possession to a purchaser within a

[84] 238 Ala. 116, 189 So. 186, *aff'd*, 308 U.S. 513 (1939).
[85] 309 U.S. 33 (1940).
[86] 309 U.S. 70 (1940).
[87] Crew Levick Co., 245 U.S. 292 (1917).
[88] 322 U.S. 327 (1944).
[89] 340 U.S. 534 (1951).
[90] *Id.* at 538.

state is based upon a local business activity which, apart from its effect on interstate commerce, is subject to the taxing power of a state; hence such a tax does not discriminate against insterstate commerce.

3. That the effect of such a tax upon interstate commerce is no different from a tax on the *use* of property which has just been moved in the channels of commerce.

In the companion case of *Felt & Tarrant Mfg. Co.*,[86] a somewhat different situation was presented. An Illinois manufacturer of business machines sold them to customers in New York City through offices located there. The orders were sent to Illinois for acceptance, and the machines were shipped directly to the purchasers, who remitted by check to the Illinois office. The Court held that the sales were subject to the New York City sales tax for the same reasons cited in the *Berwind-White* case, and that such a tax did not "lay an undue burden on interstate commerce."

Two lines of reasoning

By 1940, the courts had developed two distinct lines of reasoning. One supported the imposition of sales and license taxes; the other supported the imposition of use taxes. In general, the Supreme Court of the United States had adhered to the following principles on sales taxes and license taxes related to sales:

1. The mere movement of property in interstate commerce is not enough in itself to command exemption from taxation.

2. A state sales or license tax which is imposed upon some local business activity or event and is applicable to all such transactions on the same basis does not discriminate against interstate commerce.

3. A state sales tax laid generally on all sales in the state regardless of the source of the property does not unduly burden interstate commerce, where its only relation to interstate commerce arises from its transportation therein immediately prior to delivery to the customer.

In general, the Court had made the following determinations:

1. The movement of property in interstate commerce terminates when it comes to rest within a state and becomes part of the common mass of property therein.

2. A tax on the use, consumption or storage of such property after termination of an interstate movement is not imposed upon that commerce, and hence is not a burden upon it.

3. Such a tax imposed upon the same basis and same rates as a sales tax upon the same kind of property within the state is a compensating tax which does not discriminate against interstate commerce.

Since 1940, somewhat different judicial trends appeared. In the area of sales (and license) taxes, the cases fall into two categories: (1) those in which the property sought to be taxed moves from the taxing state to purchasers outside the state; and (2) those in which the property moves from vendors outside the taxing state to purchasers inside that state.

In the first group, the trend seems to be toward exempting all transactions from tax.[87] As foreshadowed in prior decisions, the courts have insisted that there must be a legal obligation assumed by the vendor to deliver or cause delivery of the property to the vendee outside the taxing jurisdiction. It is immaterial whether the property is shipped f.o.b. point of origin, or freight prepaid to destination. It is likewise immaterial where legal title to the property can be said to have passed in such cases.

In the second group, the trend toward unlimited application of such taxes has apparently wavered. In *J. E. Dilworth Co.*,[88] decided in 1944, the Supreme Court affirmed the Supreme Court of Arkansas in holding invalid a sales tax imposed upon merchandise manufactured in Tennessee and shipped to purchasers in Arkansas, pursuant to orders taken by telephone or by traveling salesmen. The Court distinguished the *Berwind-White* case. Although the Berwind-White Company maintained sales offices in New York City and made physical delivery of the coal there, in the present case the vendor's offices were in Tennessee, the sale was consummated in Tennessee and delivery was made in Tennessee in interstate commerce yet to flow. Thus the Court based its decision ultimately upon the fact that the "transfer of ownership" took place outside the taxing state.

A more noticeable trend away from the unlimited application of sales taxes came a few years later in *Norton Co.*[89] The Norton Company, a Massachusetts corporation having a branch office in Chicago, made sales to its Illinois customers directly and also took orders for merchandise to be manufactured and shipped from Massachusetts to Illinois customers. In certain instances, orders were taken and shipment made from the Chicago warehouse. The State of Illinois sought to apply its retailers' occupation sales tax to all sales made by Norton Company in that state. The Supreme Court denied the right to tax any part of the taxpayer's sales which were not consummated in Illinois. Said the Court, in a significant withdrawal from its previous language:

"Where a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling and delivery back to the buyer, it is obvious that the state of the buyer had no local grip on the seller. Unless some local incident occurs sufficient to bring the transaction within its taxing power, the vendor is not taxable."

The Court had now returned to the much earlier doctrine that where the taxpayer "could have approached the Illinois market through solicitors only . . . it would have been entitled to the immunity of interstate commerce" on all its sales.[90]

The Supreme Court has shown a still more definite trend away from the unlimited application of state sales taxes in a series of cases beginning with *Spector Motor Service*, decided in 1951, followed by *Memphis Steam Laundry* in 1952, *Michigan-Wisconsin Pipe Line Co.* in 1954 and *Railway Express Agency* in 1954.[91] In each of these cases, a license or privilege tax was involved, based, however, upon gross sales or receipts from doing business in the state. In each case the Supreme Court denied the right to tax in language *somewhat* as follows:

"It is enough to say that we have recently ruled that local incidents such as gathering up or putting down interstate commodities as an integral part of their interstate movement are not adequate grounds for a state license, privilege or occupation tax."

A somewhat more drastic change in

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[91] Spector Motor Serv. v. O'Connor, 340 U.S. 602 (1951); Memphis Steam Laundry v. Stone, 342 U.S. 389 (1952); Michigan-Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157 (1954); Railway Express Agency, 347 U.S. 359 (1954).
[86] 312 U.S. 359 (1941).
[88] 322 U.S. 335 (1944).
[89] 347 U.S. 340 (1954).

the trend of judicial opinion on use taxes has occurred. This change has come about largely by reason of the imposition of obligations to collect and remit taxes levied on foreign corporations. Until a few years ago, it was assumed that a state could impose virtually any type of condition upon a foreign corporation entering to do business in that state. For a good many years, the various states took advantage of this and imposed upon foreign corporations the obligation to collect and remit use taxes.

Cases sustaining states

In several cases prior to 1941 the Supreme Court had sustained the right of the state to require such compliance with its use tax statutes. In *Sears Roebuck & Co.*[92] the Supreme Court had held clearly that a mail-order house licensed to do business in Iowa may be required to collect and remit an Iowa use tax on mail orders sent in to the Chicago warehouses of the taxpayer, even though such orders were in no way solicited or obtained through local business activities in Iowa. The Court said that the unsolicited mail orders were part of the "full benefits" derived by the taxpayer from its aggregate of business activities in the state and hence subject to the use tax.

As already pointed out in reference to sales taxes, the early decisions of the Supreme Court exempted from taxation the bare solicitation of orders in a taxing state, whether by mail, telephone or traveling salesmen. As a result of depression-years psychology, the Court changed its approach. It held that where a foreign corporation maintains offices in a taxing state from which its representatives solicit orders, make adjustments, etc., the state may impose a use tax on the orders and require the corporation to collect and remit such taxes. In *General Trading Co.*,[93] the Supreme Court held that even where the corporation had no offices in Iowa and merely sent traveling representatives into the state, the use tax could be imposed since it was "a familiar and sanctioned device."

It is quite apparent now that this trend in applying use taxes has reached its high water mark and is receding. In the very recent case of *Miller Bros. Co.*[94] taxpayer, a Delaware manufacturer, sent its delivery trucks into Maryland to deliver merchandise, ordered personally or by mail orders sent to the vendor's offices in Delaware. No offices or warehouses were maintained in Delaware and no salesmen were sent in. The Supreme Court reversed the Supreme Court of Maryland which had followed the *General Trading* case, and had sustained the tax. The Supreme Court held in a surprise decision that no state has a right under the Fourteenth Amendment to require a foreign corporation to pay or collect a use tax where it was not engaged in direct selling in that state.

The effect of the Supreme Court's decision in the *Miller Bros Co.* case is problematical. That decision may easily be given several different interpretations: (1) It may well reflect a growing realization by the Court that a further broadening of the principle of taxation embraced in the *General Trading Co.* case might lead to profound and undesirable economic dislocations. (2) It may be construed as the first effort of the Court to differentiate between the methods of merchandising which subject one to taxation in a state from methods which do not. (3) It may reflect only a change in the complexion of the Court, since Justice Jackson, who wrote the dissenting opinion in the *General Trading Co.* case, wrote the majority opinion in the *Miller Bros. Co.* case.

In all likelihood the decision actually reflects a point of view embracing all three of the foregoing postulates. Justice Jackson was frank enough to say in the *Miller Bros Co.* opinion that:

"Our decisions are not always clear as to the grounds on which a tax is supported, . . . nor are all of our pronouncements during the experimental period of this type of taxation consistent or reconcilable."

Such language is quite an admission from that Court. On the other hand, Justice Jackson also said:

"[T]here is a wide gulf between this type of active and aggressive operation within a taxing state and the occasional delivery of goods sold at an out-of-state store with no solicitation other than the incidental effects of general advertising. Here there was no invasion or exploitation of the consumer market in Maryland."

If the *Miller Bros. Co.* decision means what it says, the principal import of the case is apparently that if a taxing state is to acquire jurisdiction to compel a foreign corporation to collect and remit use taxes, there must be active and continuous solicitation made directly in the state by salesmen or agents of the corporation. If solicitation results in actual sales, the other activities or events usually concomitant in consummating the transaction are more or less immaterial. Even that, however, would constitute a departure from the much earlier doctrine that the mere solicitation of business in a taxing state, without more, is not sufficient to subject a foreign corporation to use tax, or even to a service of process in that state.

Economic considerations

Various states have created exemptions arising from political and socio-economic policies. There has been present very little of the leveling influences which might have tended toward a uniform treatment of such exemptions. The sales and use tax statutes creating them are of much more recent vintage; they have not had the time to develop a period of mellowing and adjustment to each other. As a consequence, it is in this area of political and social exemptions that the greatest divergencies appear.

For example, Alabama, which enacted both a sales and use tax law in 1940, grants some nine broad areas of exemption, including farm products, farming tools, implements and fertilizer, newsprint, textbooks, tobacco products, motor fuels, and foodstuffs. Arkansas, its near neighbor, in its first sales tax law enacted in 1941, exempted only agricultural products. The present Arkansas law, which was enacted in 1947, broadens the list of exemptions to some extent. In Ohio, the area of exemptions is again a broad one, covering some 20 categories, while in Indiana virtually all types of sales are subject to the gross income tax.

It is, of course, a truism that the acts which have conferred the broadest areas of exemption from sales and use taxes have created the most difficult problems of enforcement and collection. The Ohio act is an outstanding example. It now contains some 14 categories of sales which are specifically exempt from the tax. In addition, the actual area of exemption is considerably broadened by exceptions to the definition of a retail sale. Among these exceptions are those where the purpose of the consumer is (a) to resell; (b) to incorporate into other tangible property, or to use or consume in the production of other tangible property which is to be sold;

(c) to use as security for the performance of an obligation of the vendor; (d) to use or consume in certain personal services; (e) to use or consume as evidence of a contract of insurance; and (f) to use or consume in commercial fishing.

It is in the area of exceptions and exemptions covering industrial use and consumption that the courts in all the states have had the greatest difficulty. Whether the item in question is to be used or consumed directly in the production of tangible personal property for sale by manufacturing, processing, refining, mining or in the production of crude oil and natural gas, farming, agriculture, horticulture or floriculture becomes a distressing and involved question of fact in practically every situation that is at all controversial. The courts of Ohio, for example, have been dealing with this sort of statutory language for some 20 years with a singular lack of success in settling the issue.

The courts have had equal difficulty in their attempts to determine when an item is "used directly in making retail sales," or is "used directly in the rendition of a public utility service." These are areas which are free of sales taxation in many states, either by exceptions to the definition of what constitutes a sale, or by specific exemption. Again, Ohio may be cited as an example in which courts have been entangled for years in an effort to apply a statute, which seems more vague and indefinite with each interpretation.

One point is, of course, that it is difficult if not impossible to cover the exemptions from taxation in a wide range of activities with one definition for all the types of activities which are involved. The making of a sale at retail is a completely different sort of activity from rendering a public utility service. It is difficult to understand how a legislature could apply the same definition of taxability in both situations.

A second point is that by applying the same tests of taxability to widely different types of activities the courts have become confused about the areas in which the particular test of exemption should be applied.

This statutory vagueness in defining what shall constitute a retail sale and what is excepted or exempted from taxation is true of the language found in the majority of the state statutes imposing sales and use taxes. In Oklahoma, for example, the statute lists a series of about 20 exemptions, somewhat comparable to the exemptions and exceptions under the Ohio statute, but with even more summary treatment so far as the statutory language is concerned. In Colorado the statute, while purporting to tax all retail sales other than that sold for resale, then proceeds to list some 20-odd areas of exempt sales in a series of sections analogous to the Oklahoma statute. Needless to say, the administrative agencies and the courts in these states have had endless difficulty in attempting to apply the exemptions.

In conclusion it should be observed that in those states where sales and use taxes have become substantial sources of revenue, the primary concern of the administrative officials has been with regard to exemptions. This has become increasingly so in the years since 1945, when virtually all those states have been forced into greatly expanded governmental functions with no corresponding expansion of the sources of revenue. Definite efforts are being made by the tax administrators in many states either to reduce greatly the areas of exemption or to eliminate them altogether, in favor of a reduction in the rate of taxation. It would appear, therefore, that unless the imponderable arguments of political consideration take over, the virtual elimination of exemptions in this area may win out in the race with uniformity. ☆

Miscellaneous new decisions this month

End-use test for dolomite depletion invalid (1939 Code) [*Acquiescence*]. The Code allows 10% depletion for dolomite and 5% for limestone and calcium carbonate. The Commissioner took the position that the three are chemically indistinguishable and that end use determines which amount is allowable. The court finds that Congress used the word in its ordinary meaning and that legislative history showed that a specific provision (as for dolomite) should supersede a general (as for rock, calcium carbonate or limestone). [The 1954 Code provides for an end-use test in determining whether dolomite is depleted at 5 to 15%. *Ed.*] *Virginian Limestone,* 26 TC 553, *acq.* IRB 1957-25.

End-use test not applicable in determining percentage depletion for dolomite (1939 Code). In accordance with its acquiescence in *Virginian Limestone,* 26 TC 553, (above), any limestone rock which has a magnesium carbonate content of 35% or higher will be treated as dolomite and entitled to percentage depletion at a flat rate of 10%. Limestone rock which does not contain at least 35% of the magnesium carbonates will continue to be classified on the basis of the end-use test. *Rev. Rul.* 57-288.

"Chemical grade" limestone distinguished from calcium carbonate; higher depletion rate allowed (old law). In 1950 and 1951, taxpayer was engaged in the quarrying and processing of limestone. The court agrees with taxpayer that the processes of original quarrying, crushing, heat treatment to remove moisture, and pulverization, which taxpayer applied to arrive at its product were "ordinary treatment processes" normally applied to obtain such commercially marketable product. Taxpayer contended that its product was "chemical grade" limestone, and that the statutory depletion rate of 15% applied, whereas the Commissioner argued that the product was pure calcium carbonate for which the statutory depletion rate was 10%. The court said that under the general understanding of the term, taxpayer's product was chemical grade limestone and entitled to 15% depletion. It again rejects the end use test as it did in Virginian Limestone, 26 TC 553. [The Commissioner has acquiesced in *Virginian Limestone.* Apparently, the argument here is inconsistent with acquiescence.—*Ed.*] *Iowa Limestone Co.,* 28 TC No. 96.

Must have economic interest in the mineral to claim percentage depletion. Taxpayers acted as one of several contractors who did the actual mining for a coal land holder. Taxpayers mined coal and delivered it at a prearranged price for further processing. Taxpayers' only investment was in movable machinery and the costs of opening and operating the mine. It had no right to mine a fixed quantity of coal or coal in a fixed location and the contract was terminable by either party at will. The court holds that taxpayers were paid for services and did not acquire an economic interest in the mineral, hence they are not entitled to a percentage depletion allowance. *Stilwell,* DC Va., 5/23/57.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

LoBue-type tax may hit partner who gets capital share for services: a warning

TAX MEN ARE STILL worried about the application of the *LoBue* rationale to partnerships and see a tax trap here for the unwary partner. Philip LoBue was, of course, a corporate employee. He was taxed at ordinary income rates on his bargain purchase of stock of the employer under a stock option plan, and the Supreme Court grounded its opinion on the finding that the bargain was compensation. What is the position of a partner given an interest for services? When is it income? How is the interest valued? Can other partners take a deduction?

Can a partnership give service partners an interest in the business without disastrous tax consequences? The Code has elaborate provisions to permit corporations to bring executives in through the use of stock options, but it is silent on how a partnership can achieve the same end.

Typically, this problem arises in partnerships holding mineral interests, although it is by no means confined to them. Any partnership holding valuable properties, unable or unwilling to incorporate, and forseeing the possibility that the partners are going to realize their gains as capital gains on sale of their interests of the properties, may well be faced with the problem of how to give partners who have made no investment an interest in the partnership capital.

Section 721 of the Code says merely that "no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." The Regulations, however, take the position that this does not apply to a contribution of services. They provide, in Section 1.721-1(b)(1), that "normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), Section 271 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under Section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest."

Taxation Section proposals

At the recent meeting of the Section of Taxation of the American Bar Association, the Committee on Partnerships made some suggestions for changes which were the subject of considerable discussion on the floor. (See box.) This year, the Committee proposed specific provisions covering the determination of and accounting for such income. In addition, the Committee proposed an exception to the general rule that such an interest is income. However, the Section did not act on this proposal.

In 1956, they had proposed the exception of services rendered in the development of mineral properties of the partnership. This year the exception they proposed was much broader: that of any interest acquisition of which would not be the receipt of income under the general definition of income in Section 61(a).

Here's how the Committee explained its proposal: "At the 1956 Annual Meeting of the Section of Taxation, this committee submitted a legislative recommendation for amendment of Section 721 which specifically provided for the taxation of income to a partner who received a capital interest in a partnership in consideration for his services. The amendment reflected the provisions of the Regulations (Section 1.721-1(b)(1)) that Section 721 does not apply to the extent that an interest in partnership capital is obtained by a partner as compensation for services and not in exchange for a contribution of property to the partnership. The legislative recommendation provided that the rule would not apply to the extent such capital interest was acquired in whole or in part as the result of services rendered in the development of mineral properties of the partnership. The exception was intended to produce the same tax result whether mineral properties were developed in a partnership or some other business arrangement. After a vigorous debate, the Section referred the matter back to the Committee.

"The Committee has reconsidered this matter and renews its legislative recommendation with, however, a somewhat broader exception. Such a legislative amendment is warranted in the interest of sound tax administration and may forestall statutory changes which could have the undesirable effect of taxing an interest in profits received as compensation for services as well as a capital interest received as compensation. The exception to the proposed rule, however, should not be confined to mineral properties inasmuch as the same problem may arise in non-mineral activities. The fundamental purpose of the exception is to preclude taxation where the interest acquired by the service partner would not have been taxable income if such an interest had been acquired under circumstances not constituting a partnership. The exception is intended, for example, to conform the partnership provisions with existing rulings and case law with respect to the development of mineral

properties. Consequently the same treatment will prevail whether the development of the properties is in a partnership or under an arrangement that does not constitute a partnership.

"A further change in the legislative recommendation as presented at the 1956 Annual Meeting of the Section of Taxation occurs with respect to a capital interest transferred as compensation for services where the capital interest transferred is subject to conditions or restrictions at the time of such transfer. If the conditions or restrictions are sufficiently onerous, there may be no income realized by the partner receiving the capital interest as compensation for services at the time said capital is transferred to him. Correspondingly, no deduction would be allowed to the other partners at the time of the transfer of the capital interest subject to such conditions or restrictions. The law is uncertain as to the time of realization of income when the conditions or restrictions are later removed. There may be a considerable appreciation in value from the date that the capital interest was transferred to the service partner subject to conditions or restrictions and the time of either removal of such conditions or restrictions or the realization of gain by the service partner through sale or retirement of the capital interest acquired for services. In order to prevent the appreciation in value of the capital interest which occurred after the transfer of the capital interest from being included in the measure of income to the service partner (and in the measure of deduction by the other partners), it is proposed to limit the amount of income realized by the service partner and the amount of the deduction allowable to the other partners to whichever is the lesser of (A) the fair market value of the capital interest at the time transferred if it had not been subject to conditions or restrictions or (B) the fair market value of the services rendered or to be rendered by the service partner.

". . . Where a partner is taxable upon receipt of a capital interest for services, the amendment allows an equivalent deduction to the other partners if a deduction would have been allowable if cash had been paid for such services. The allowance of a deduction to the other partners also requires a provision to treat the transfer of the interest to the service partner as a sale or exchange by the transferor partners.

ABA PROPOSAL ON INTEREST FOR SERVICES

THE COMMITTEE on Partnerships of the Section of Taxation of the American Bar Association proposed the following new sub-section to be added to Section 721: CAPITAL INTEREST TRANSFERRED FOR SERVICES: GENERAL RULE.—If a partner acquires an interest in the capital of a partnership in exchange, in whole or in part, for his services—(A) no gain or loss shall be recognized to the partnership; (B) an amount equal to the fair market value of the interest in the partnership capital acquired in consideration for services shall be included in the gross income under Section 61(a) of the partner receiving such capital interest; (C) there shall be allowed as a deduction under Section 162(a) to the other partners a total amount equal to the amount includible in gross income under subparagraph (B) of the partner receiving such capital interest, providing such amount would have been deductible had it been paid by them in money, and (D) the other partners shall be considered to have sold, for an amount equal to the deduction allowed them under subparagraph (C), a portion of their capital interests in the partnership, and gain or loss on such sale or exchange shall be determined as provided in Section 741 and Section 751(a).

LIMITATION ON GENERAL RULE.—If an interest in the capital of a partnership is transferred in exchange, in whole or in part, for the services of a partner subject, at the time of such transfer, to conditions or restrictions, in no event shall the amount included in income or allowed as a deduction pursuant to paragraph (1) exceed whichever is the lessor of—(A) the fair market value of the capital interest at the time transferred, in whole or in part, as compensation for services if such capital interest had not been subject to conditions or restrictions at the time of such transfer, or (B) the fair market value of the services rendered or agreed to be rendered as consideration for the transfer, in whole or in part, of such capital interest in the partnership.

EXCEPTION.—This subsection shall not apply to the extent that the acquisition of an interest in the properties of the partnership for such services, under circumstances not relating to a partnership, would not be taxable under Section 61(a).

"The capital interest acquired by the compensated partner may have substantial conditions or restrictions on its withdrawal or disposition. Such conditions or restrictions affect the time of realization of income and also the fair market value of the property received. It is contemplated that such restrictions and conditions are to be taken into account, under the proposed amendment, in determining the time and amount of the income realized." ☆

New partnership decisions this month

Capital gain on sale of deficit capital account to partner. Taxpayer's basis for his interest was zero and since he had withdrawn more than his capital and share of the profits of the partnership his account showed a deficit when he sold his partnership interest to his partner for cash. [The Ruling is not clear on the point but apparently taxpayer was one of two partners.—*Ed.*] The deficit was forgiven. The Ruling notes that the partnership owned no unrealized receivables or appreciated inventory and that therefore Section 751 (which would treat proceeds allocable to such assets as ordinary income) was inapplicable. The cash received for the sale of the interest is capital gain as provided by Section 731: "In case of a distribution by a partnership to a partner . . . gain shall not be recognized . . . except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership . . . Any gain . . . recognized under this subsection shall be considered as gain . . . from the sale . . . of the partnership interest . . ." In accordance with the Regulations, Section 1.731-1(3)(2) the cancellation of the obligation to repay the deficit is also treated as a distribution by the partnership and a capital gain. *Rev. Rul.* 57-318.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

What is the difference between costs and expenses for tax purposes?

As SAD EXPERIENCE in many parts of the world shows, it is impossible to have a just and productive income tax without universally used and highly developed accounting techniques. In this country, fortunately, the two grew together and it is impossible to say which was cause and which effect. But their developments have been far from parallel.

Consider terminology, for instance. The amendment had to be adopted, the first statutes written and regulations drafted, all in accounting terms at a time when little attention had been paid by professional accountants to just what the terms meant. Indeed, for one reason or another, development of authoritative standards of terminology has been very slow.

In recent years, the Committee on Terminology of the American Institute of Certified Public Accountants has been working on the difficult task of defining fundamental terms. Their Bulletin No. 4, defining cost, expense and loss (set out in the adjacent box) came to us at about the same time we were reading an excellent study of the meaning of these words in the Code, prepared by the editors of the Minnesota Law Review (41 Minn. L. Rev. 368).

The accountants' bulletin is in accord with the modern trend toward obliterating the distinction between various hierarchies of costs—of manufacture, of sale, of administration. But there is firmly imbedded in the law the idea that only income can be taxed—there are certain costs which under the Constitution must be allowed, whereas expenses are a matter of grace of Congress. The courts are forced to draw a line between them, and they have not found it easy.

The particular case which attracted the attention of the Minnesota editors was that of a bookmaker who, a jury had found, had $600 gross income and failed to file a return. The precise question was whether the Government's evidence of some $22,000 paid to him by losing bettors who recovered on $17,000 was sufficient proof of gross income over $600, or did the Government have to show that he had a net of $600 after payment to winning bettors? (*Winkler*, 230 F. 2d 766 (1st Cir. 1956)). The court held (with one judge dissenting), that the conviction was in error. The Government had not proved he had gross income of $600; Congress cannot deny a bookmaker the right to subtract losing bets from winning bets in each race for the purpose of determining gross income. Losing bets are equivalent to cost of goods sold because they represent necessary and inevitable payments in each race.

"The specific issue in this case," the editors said, "that of defining 'gross income' as used in Code sections fixing reporting requirements, is a segment of the more fundamental problem of defining that 'income' of a business entity which is subject to the Federal income tax. Under the prevailing interpretation of the Sixteenth Amendment, only receipts in excess of capital outlay are said to constitute 'income.' The *Winkler* decision is based in part on the hypothesis that for a business activity the 'cost of goods sold' is equivalent to 'return of capital' and must be deducted from receipts in the computation of income which Congress can tax. While this limitation is not explicit in the Sixteenth Amendment, it is supported by the Treasury Regulations that interpret the Internal Revenue Code. The Regulations subtract 'cost of goods sold' from total sales in the computation of 'gross income from business.' Although they do not expressly classify cost of goods sold as return of capital, it would seem that this can be inferred from another Regulation which, in effect, defines 'gross income' as gross receipts less return of capital and income that is exempt from taxation.

"The courts have indicated that they equate a business' cost of goods sold to return of capital in cases involving the taxpayers' right to reduce gross income by the portion of the cost of goods sold which is in excess of ceiling prices. However, these decisions avoided interpretation of the Sixteenth Amendment and turned instead on whether Congress had exercised its power to provide civil sanctions to enforce its laws. Thus the Wage Stabilization Act of 1942 empowered government officials to disregard payments in violation of the Act in determining costs and expenses for the purposes of other laws and regulations. As a result, the disallowance of direct labor costs—commonly recognized as a cost of goods sold—was upheld under the Act. On the other hand it was held that the Commissioner could *not* disregard the cost, in excess of O.P.A. ceilings, of goods acquired for resale where the applicable act did not contain such a sanction. . . .

Cost as return of capital

"If the 'cost of goods sold' of a business is to be equated to 'return of capital,' which by hypothesis Congress cannot tax under the Sixteenth Amendment, the elements of 'cost of goods sold' must be distinguished from those outlays constituting business expenses that are allowable as deductions from income only by legislative grace. The basic problem is that it is difficult to make a logical distinction between business 'costs' and business 'expenses.' Where the assets are purchased and resold by a merchant without a substantial change in form, it *may* perhaps be said that the cost of goods sold constitutes a capital outlay which is logically distinguishable from the merchant's operating expenses. But for agricultural or manufacturing enterprises where the goods sold are produced from raw materials and labor, the logic of a distinction between 'costs' which must be recovered from receipts before there is 'income' which Congress has the power to tax, and 'expenses' which Congress can allow or disallow at its pleasure, is questionable indeed.

"There seems to be no economic reality in a constitutionally required distinction between sums spent by a manufacturing corporation to pay an as-

sembly line worker or to purchase raw material on one hand, and expenditures to pay the salary of the sales force or to pay interest on money borrowed to purchase the raw material on the other hand. The former are regarded as costs of goods sold and the latter as expenses. But *all* of these expenditures represent capital outlay necessary to produce the revenue that the corporation receives for products it manufactures and sells. Recoupment of one type of expenditure is as necessary as recoupment of the other if there is to be a 'return of capital.' And the same reasoning would seem to render questionable a constitutional limitation on the Federal taxing power, which distinguishes between the cost of goods acquired by a business for resale and the equally important costs of marketing the goods.

"The tenuousness of the distinction notwithstanding, it seems fairly clear that the courts will regard the cost of goods *acquired for resale* as constitutionally different from expenses incurred in marketing the goods. However, the Tax Court, although criticized, has indicated that it will permit disallowance of the direct costs of *producing* goods sold, at least to the extent it finds them unreasonable. While the position of the appellate courts is not clear on this point, there are indications that they will take the opposite view.

"In determining what receipts are subject to a tax on 'income,' the judiciary is no doubt influenced by traditional accounting concepts and common usage and understanding. For the unusual type of profit-making activity such as that involved in the bookmaker's case, these criteria afford little aid. This court likened the professional bookmaker to a merchant selling chances to win money. This pattern of approach—analyzing the nature of the operation to determine what part of receipts constitute return of capital—is probably sound. But because there was nothing 'sold' in the normal business sense, there was no place to draw the traditional conceptual line between 'costs' and 'expenses.' The losing bets in each race were said to be costs which must be recouped as return of capital since they represented necessary and inevitable payments that induced the customers to wager, sustained the entire operation, and without which the operation could have produced no receipts. This argument seems to be one of those that proves too much, for if the test of constitutionally protected 'return of capital' is whether the expenditure is necessary to sustain the operation, every expense of the ideally managed business could qualify. Thus the court, in effect, adopted a *net income* approach.

"It is significant that the dissenting judge made the same analysis of the nature of the operation as did the majority, and was also unable to draw the traditional line between costs and expenses because of the unusual type of 'sale.' Yet while the dissenter did not advocate a *gross receipts* approach, he reached that result for the bookmaker's operation by looking to the unit of 'sale.' Thus if a casual investor owns two blocks of stock and sells one at a profit and the other at a loss, the loss is not required by the Sixteenth Amendment to be set off against the gain to determine gross income; and so, the

HOW ACCOUNTANTS DEFINE COST, EXPENSE AND LOSS

Accounting Terminology Bulletin No. 4, prepared by the Committee on Terminology of the AICPA says:

"*Cost* is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received. Costs can be classified as unexpired or expired. Unexpired costs (assets) are those which are applicable to the production of future revenues. Examples of such unexpired costs are inventories, prepaid expenses, plant, investments, and deferred charges. Expired costs are those which are not applicable to the production of future revenues, and for that reason are treated as deductions from current revenues or are charged against retained earnings. Examples of such expired costs are costs of products or other assets sold or disposed of, and current expenses. Unexpired costs may be transferred from one classification to another before becoming expired costs as above defined, e.g., depreciation or insurance on plant may be included in unexpired costs ascribed to inventories.

"*Expense* in its broadest sense includes all expired costs which are deductible from revenues. In income statements, distinctions are often made between various types of expired costs by captions or titles including such terms as cost, expense, or loss, e.g., cost of goods or services sold, operating expenses, selling and administrative expenses, and loss on sale of property. These distinctions seem generally useful, and indicate that the narrower use of the term *expense* refers to such items as operating, selling or administrative expenses, interest, and taxes.

"*Loss* is (1) the excess of all expenses, in the broad sense of that word, over revenues for a period, or (2) the excess of all or the appropriate portion of the cost of assets over related proceeds, if any, when the items are sold, abandoned, or either wholly or partially destroyed by casualty or otherwise written off. When losses such as those described in (2) above are deducted from revenues, they are expenses in the broad sense of that term.

"The term *cost* should be used when appropriate in describing the basis of assets as displayed in balance sheets, and properly should be used in income statements to describe such items as cost of goods sold, or costs of other properties or investments sold or abandoned.

"While the term *expense* is useful in its broad and generic sense in discussions of transactions and as a general caption in income statements, its use in financial statements is often appropriately limited to the narrower sense of the term. . . . In any event, items entering into the computation of cost of manufacturing, such as material, labor, and overhead, should be described as costs and not as expenses.

"The term *loss* should be used in financial statements in reference to net or partially net results when appropriate in place of the term income or profit . . . . In such cases the term should generally be used with appropriate qualifying adjectives. It should also be used in describing results of specific transactions, generally those that deal with disposition of assets. The use of the term in the latter type of cases is believed desirable since it distinguishes them from more normal expenses of a recurring type which are generally shown in gross amounts." ☆

argument goes, each wager made by a professional bookmaker is a separate 'sale' unrelated to the others and losing wagers are not required to be set off against winning wagers, either in each race, or, as the majority suggested without deciding, over the annual accounting period.

"It may be argued that the analogy between the merchant and the bookmaker is a poor one or that the court divided only over the 'unit of sale' point, but the manner in which the *Winkler* case was reasoned would seem to point up the fundamental fallacy of a distinction between business 'costs' and business 'expenses' for determining Sixteenth Amendment income.

"The elimination of the distinction would force a choice between gross receipts and net income as the Sixteenth Amendment limitation on 'income' from *business operations.* If both choices appear offensive, these factors should be considered: First, as a practical matter, it is most unlikely that Congress will ever enact a statute exacting a general graduated tax on either gross receipts *or* gross income from business activity with no provision for offset of expenses or costs incurred in earning the income. Thus the operative effect of defining business income as gross receipts would be to permit the disallowance of some 'cost' items for policy reasons just as some 'expense' items are now disallowed. Second, it is reasonable to argue either that Congress should have *no* power to deny the right to set off all necessary expenditures against business receipts, or that Congress *should* have the power to deny the right to set off any necessary expenditures for policy reasons; but it does not seem reasonable to insist that *some* necessary expenditures are sacrosanct and others not. ☆

When can the pre-1954 150% declining balance method be used?

RECENT LETTERS from readers indicate that some revenue agents have questioned the continued use of the 1939 Code 150% declining balance method of depreciation. The recent issue of *Rev. Rul.* 57-352 (IRB 1957-31, 8/5/57), makes it quite clear that the 150% declining balance method may continue to be used for *new* or *used* tangible property acquired prior to January 1, 1954, and for *used* tangible property acquired after December 31, 1953, provided such method results in a reasonable allowance for depreciation.

The question may be asked also as to the use of the 150% declining balance method for *new* tangible property acquired after December 31, 1953. The new Ruling states that IT 3818, Cum. Bull. 1946-2, 42, provided for the use of the declining balance method of computing depreciation if it were regularly used in keeping the books and if it resulted in reasonable depreciation and a proper reflection of net income. It is then stated that "the application of IT 3818 is *restricted* to new or used property acquired prior to January 1, 1954, and used property acquired after December 31, 1953."

While IT 3818 does not specify the 150% rate, the intention of *Rev. Rul.* 57-352 appears to be that the 150% limitation that was effective under the 1939 Code (see NHA Release No. 583, September 4, 1946) is implied in IT 3818. Thus the 150% rate (as implied in IT 3818) is restricted to *used* property acquired after December 31, 1953 and not applicable to *new* property acquired after December 31, 1953. Some authorities (see Montgomery's *Income Tax Procedure,* 36th Ed.) have said that the use of the 1939 Code 150% method is so restricted.

It could be argued that such a restriction has little practical significance since the 200% declining balance method can be used for all *new* property acquired after December 31, 1953. However, in some jurisdictions such as California, it is of more than academic interest to have the situation clarified. The California law has not been conformed to the 1954 Federal law and contains no provision which will permit the use of the 200% declining balance method. The California Franchise Tax Board has taken the position that this method, although permitted by Federal law, is not allowable for California tax purposes. However, the Board will allow any reasonable method of computing depreciation, *including the 150% declining balance method* as applied under the 1939 Federal Code. Thus some of the advantages in using 200% declining balance depreciation for Federal purposes may be more than offset by the accounting complications involved in keeping two sets of depreciation records in order to meet the California franchise tax requirements. Under these circumstances the use of the 150% declining balance method may be preferred for *new* assets acquired after December 31, 1953.

It is our opinion that the intention *Rev. Rul.* 57-352 is merely to permit the continued use of 150% method for *used* assets acquired after December 31, 1953 without in any way denying the use of the 150% rate for new assets. While IT 3818 and the old 150% method is restricted by the new Ruling to *used* assets, the 150% rate could still be utilized in accordance with Section 167(b)(2), since the 150% rate would not exceed the 200% allowed under the new rule in the 1954 Revenue Code.

This conclusion is based on the fact that Section 167(a) of the 1954 Code was taken directly from Section 23(l) of the 1939 Code. The old rules on depreciation including IT 3818 and the acceptance of the 150% declining balance rate are still applicable to assets covered by Section 167(a) but not covered by Section 167(b). This is made clear in *Rev. Rul.* 57-352. In addition *Rev. Rul.* 57-352 liberalizes the old rules by permitting the use of the 150% declining balance method "regardless of the method of computing depreciation employed for other depreciable property." Under the prior Regulations this method could be used only if applied consistently to all property of the same type or class, and a change to this method from another was considered to be a change of accounting method requiring approval of the Commissioner.

Section 167(b) providing for accelerated depreciation for new assets with a life of three years or more is new in the 1954 Code. The old depreciation rules are not applicable to those assets. However, Section 167(b)(2) permits declining balance depreciation *not exceeding 200%.*

Based on this analysis of *Rev. Rul.* 57-352, the 150% declining balance method may be utilized for new or used tangible property acquired prior to January 1, 1954, and for used property acquired after December 31, 1953, and may also be utilized for new assets acquired after December 31, 1953 under Section 167(b)(2) of the 1954 Code. ☆

New accounting decisions this month

Can't deduct release of claim for unpaid salary; was part of estate settlement. For many years prior to their father's death in 1925, taxpayers had worked in their father's unincorporated coal business. They were credited with, and paid income tax on, salaries only part of which they actually withdrew. Although the business was incorporated shortly before the father's death, the liability for the unpaid salaries was not assumed by the corporation but remained as an obligation of the father, and later of his estate. There was litigation over the will, and a 1930 family agreement settling it, and a 1942 suit brought by taxpayers' sisters charging mismanagement of the corporation by the brothers and finally in 1946 a settlement in which, among other things, the taxpayers cancelled their claim for the old unpaid salary accounts. They claimed a deductible loss in that year. The Tax Court holds they are not deductible; the cancellation was part of the settlement of the estate; it was not a loss incurred because of the management suit. *Dietz Estate,* TCM 1957-116.

License suspended; standby costs are capital, not deductible. Taxpayer had operated a licensed business (nature of the business not specified) prior to and after the year here in issue. In 1947 however, he had no license, he returned his stock to the wholesaler and made no sales. He did incure rent and other costs. These, the court holds, he may not deduct in 1947. These costs are in the nature of a capital investment in preparation for future business. *Penton,* DC Tenn., 7/1/57.

No deductible loss when Supreme Court ordered AP to admit all newspapers. Taxpayer had purchased assets of functioning newspapers including their memberships in the Associated Press, giving the corporation an exclusive right to AP services in its area. Taxpayer's cost for the AP franchises was some $82,000. In 1945, following the Supreme Court decision that giving one newspaper in each area an exclusive franchise was an illegal restraint of trade, the wire service discontinued its exclusive feature, and taxpayer claimed a loss of the $82,000 basis of its franchise. The court finds no difference between this case and three others in which it denied such a deduction. Taxpayer continues to use AP; at most there was a diminution in value but no realized loss. *Star-Journal Publishing Corp.,* Ct. Cls. 7/12/57.

Contingent fee not deductible until settlement effected. In 1952 taxpayer agreed to pay a CPA 50% of any reduction he might secure in asserted tax deficiencies. She also agreed to pay him $2500 on account which was to be in full payment if no reduction were secured. A settlement was effected in 1955. The court denies taxpayer an accrual of audit fees in excess of $2,500 during 1952-1954. There was no way of knowing before settlement in 1955 how much, if any, reduction would be secured, and until then, taxpayer incurred no liability in excess of $2,500. Claimed medical expenses were denied for failure of proof. *Rand,* TCM 1957-132.

Loss denied for year of embezzlement. In 1946, taxpayer's agent deposited in his own bank account $30,000 which had been remitted to taxpayer by a customer. The fraud was not discovered until 1950 when the customer brought suit for his merchandise. In 1953, taxpayer paid $20,000 to settle the claim. Recovery from the agent was impossible. Since the taxpayer was on the accrual basis, it filed claim for refund of 1946 tax. The denial of taxpayer's claim is affirmed. A loss is not inevitably sustained when embezzlement occurs; restitution may be made. The court holds that $20,000 is properly deductible in 1953. *Ismert-Hincke Milling Co.,* CA-10, 7/11/57.

CAPITAL GAINS

Capital loss on reduction of sale price of capital assets. In 1947 taxpayers sold their interests in a partnership, the initial payment to be made in 30 days and the balance in three installments during 1948 and 1950. Later in 1947 taxpayers agreed to accept a smaller immediate payment in place of the installments due in 1948 and 1950. They did this because they needed funds for their new business. The Tax Court held it was a capital loss relating back to the original transaction. This court affirms. *Wener,* CA-9, 3/25/57.

Bottler has ordinary income on bulk sale of whiskey bought to insure supply. Taxpayer, the Boston wholesale and retail grocer, also operated a whiskey bottling plant. It generally contracted annually with distillers who delivered the whiskey to bonded warehouses through the year and taxpayer withdrew the whiskey as needed. In 1942 it adopted the policy of buying all the bulk whiskey it could. The dominant purpose was to insure supply. All whiskey was recorded in the same way and maintenance costs all treated as inventory. The court finds as a fact that the whiskey was always held as inventory for sale in the ordinary course of its business. Thus sales in bulk in 1948 and 1949 resulted in ordinary income. The court adds that even if the purpose for the holding had changed, as the taxpayer claimed, to investment early in 1948, the tax result would be unaltered. A taxpayer's determination that he is no longer holding property for use in the business cannot be permitted to transmute ordinary income into capital and to defeat the intent of Congress to tax ordinary business income at ordinary rates. *S. S. Pierce Co.,* DC Mass., 7/18/57.

Court will determine whether it's a lease or an installment sale from facts, not labels. Taxpayers entered into a "lease and purchase option" of a business building they owned and reported the annual proceeds as rental income in their income tax returns for a number of years. They now file for a refund, claiming that the transaction was actually an installment sale and thus entitled to capital gain treatment. The court finds that the parties intended a sale and orders the refund sought. *Elliot,* DC Mont., 6/27/57.

Capital gain on transfer of unpatented invention to employer. Taxpayer, an employee, had been working in his spare time for 15 years to discover a method of making multiple copies of steel stamps. He finally perfected a steel stamping machine, the rights to which he assigned to his employer before having it patented. Though the original assignment had been lost, the court determines from other evidence that the entire right to make, use and sell had been transferred. It was therefore a sale and the percentage payments received after the transfer are part of the purchase price for the invention, not royalty

income. Accordingly he is held to have properly treated the payments as long-term capital gain. *Speicher,* 28 TC No. 104.

Patents were held for sale to customers, income is ordinary. The Court finds that taxpayer had from 1934 to 1951 followed the practice of developing an idea, generally in the medical field, interesting some manufacturer, joining the staff of the manufacturer to develop the idea and granting the manufacturer an exclusive license. His compensation typically was a salary plus royalties. The court concludes that the patents were held for sale to customers in the ordinary course of taxpayer's business and the income is therefore ordinary. *Lockhart,* TCM 1957-114.

Taxpayer not a real estate dealer; sale of tracts is capital gain. Taxpayer's principal business activity was as a mortgage broker. He also held several rental properties. In 1946 he acquired two adjoining tracts of raw acreage. He platted the tracts for residential purposes and installed some sewer tile, but did nothing further towards the sale of the property. In 1949 he sold the entire property in a single transaction. The court finds that his passive attitude puts him in the category of investor, rather than a dealer in real estate. The gain is capital. *Carruth,* DC Tex., 7/26/57.

Assembling phosphate acreage for saleable parcels is a business; gain on other land capital [*Acquiescence*]. The Tax Court held that taxpayer, a cattle rancher, timber grower and real-estate broker realized ordinary income from sales of phosphate-bearing acreage which, by purchase and options over a period of years, he assembled into parcels sufficiently large to attract a customer. However, two other tracts were not in any way connected with the business of assembling and selling the phosphate-bearing lands. Gain on these is capital. *Thomas,* 28 TC No. 1, *acq.* IRB 1957-29.

Can use alternative capital gains tax though return did not [*Acquiescence*]. Taxpayer's accountant failed to fill out the alternative capital gains tax computation; she signed the return and paid the higher regular tax. The court holds that she is entitled to the benefit of the alternative rate. The Code imposes no requirement of election and the Commissioner may not do so. *Taylor,* 27 TC 361, *acq.* IRB 1957-29.

No bad debt; settlement of $65,000 note for $500 was a sale. Taxpayer corporation sold the stock of its wholly-owned subsidiary (which owed it $65,000). Shortly thereafter the purchaser told taxpayer that he considered the company he had bought a failure unless additional money was invested, which he would not do with the $65,000 note outstanding. He offered $500 to settlement; taxpayer accepted, and claimed a $64,500 bad debt loss. The court finds the transaction was a sale and the loss is therefore capital. The deficiency in this case was some $16,000; the sale for $500 thus cost over thirty times that in tax. *Von Hoffman Corp.,* TCM 1957-127.

Movie rights to Gershwin music were sold; gain is capital. Mrs. Gershwin, taxpayer here, inherited some of her son George's musical compositions, which she transferred to a movie company for $150,000. She reserved very limited rights in all compositions, special limitations in two songs and the right to have a reversion of title in any composition not used by the movie company. The court holds that the transaction was a sale, not a license. Taxpayer's gain is capital. *Gershwin,* Ct. Cls., 7/12/57.

DEPRECIATION

Lease reasonably certain of renewal; lessee's improvements depreciable over physical life. Where stock ownership in a lessee by the lessor and/or his family, or other circumstance, makes it reasonably certain that a lease can be renewed beyond its stated term, the cost of permanent improvements made by the lessee should be depreciated over their useful lives. *Rev. Rul.* 57-361.

Rules outlined for use of 150% declining balance method of computing depreciation. For new or used property acquired prior to January 1, 1954, and used property acquired after December 31, 1953, use of the 150% declining balance method of computing depreciation is permitted (1) to a new taxable entity in an initial return; (2) if permission to use such method has been granted by the Commissioner; (3) if the method is elected in the first return in which depreciation is sustained; (4) for taxable years after December 31, 1953, if the method is elected in the first year in which the property is subject to depreciation regardless of the methods employed for the other depreciable property. [See comment page 214.—*Ed.*] *Rev. Rul.* 57-352.

Must amortize leasehold cost over its term, not life of building thereon. Taxpayer's partnership acquired a leasehold with 97 years to run. At the time there was on the land a building with an estimated life of 20 years. The court holds the leasehold must be amortized over the full 97 years. It holds that taxpayer may not amortize its cost for the leasehold over the 20-year remaining life of the building. Taxpayer had not erected the building as its improvement on a leasehold; it had no depreciable interest in the building. Nor could the cost be amortized over 25 years, though the partnership had the right to terminate the lease at the end of the 25th, 50th and 75th year by giving one year's notice. The court holds that a lease for 99 years with options to terminate is not the equivalent of a lease for a shorter period with options to renew. *Dab,* 28 TC No. 103.

Contractor can't amortize property owned by the Government. Taxpayer constructed emergency facilities for the Government and was reimbursed in monthly installments. The court denies taxpayer amortization. Though technical title was in it, taxpayer did not really bear the cost and had no risk of loss. This court agrees with *Milnor* (85 F. Supp. 931) that just as only the real owner can claim depreciation, only he can claim amortization. *Lake Erie Engineering Corp.,* DC N. Y., 3/29/57.

Depreciation and loss on slot machines denied. A gambling partnership is denied depreciation deductions on slot machines having failed to show what was paid for the machines, their useful life, and the amount allowed or allowable in prior years. A loss occasioned by the confiscation and destruction of the machines by state authorities is also disallowed there being no showing that the machines had any basis to the partnership. *Delsanter,* 28 TC No. 94.

WHAT IS INCOME

Accounts in relatives' names were taxpayer's; "interest" paid on them not income [*Acquiescence*]. Taxpayer maintained various commodity trading ac-

counts in the names of three relatives, which, the court concluded, were in reality accounts of the taxpayer. It follows that the relatives did not have a valid debt to taxpayer for advances to the accounts and she is not taxable on $100 paid to her as interest; it is not interest on a valid debt and is not taxable income. *Taylor,* 27 TC 361, *acq.* IRB 1957-29.

Stock was not received for services; not income. The Commissioner asserted that taxpayer received stock in a corporation as compensation for services and that its value was taxable income. The court agrees that based on book entries alone that might be a reasonable interpretation of the transaction. However, it accepted taxpayer's testimony that he performed no services for the corporation and that certain cash he had advanced was in reality in payment for the stock. *Perkins,* TCM 1957-128.

Interest on installment notes for equipment sold to states is tax exempt. Taxpayer sold equipment to Kansas and Missouri and political subdivisions. It claimed that interest included in installment sales was tax exempt. The court agrees as to those written contracts which specifically provided for interest. The court was not convinced by the Government argument that such installment contracts were illegal under the state "cash basis" law. If contracts are fully executed and no fraud exists the Tax Court policy is to give them effect. The burden is on the government to prove that they were illegal. *Newlin Machinery Corp.,* 28 TC No. 93.

Cooperatives' revolving fund certificates were capital contributions, not debts; no income on cancellations. Taxpayer, a cooperative membership corporation, had in prior years made annual levies against its members for which it issued "retain certificates." In partial liquidation about one half of the certificates were cancelled. The Commissioner contended that taxpayer realized income from cancellation of indebtedness. The court, however, finds that the certificates were not debt because they had no fixed principal sum, bore no express promise to pay, carried no interest, were subordinated to the debts of creditors and could not be enforced in the event of a default. Not being debt, the certificates were capital and therefore the cooperative realized no gain on cancellation. *Pasco Packing Ass'n,* DC Fla., 6/23/57.

Estate's collection of "worthless" debt taxable as ordinary income. At the time of decedent's death his son owed him $50,000. On the Federal estate tax return the debt was valued at zero and the Tax Court finds its value then was in fact zero. Later, the estate collected $18,000 on the debt, none of which it included in income. The court holds since the adjusted basis of the debt was zero all of the collections constituted gain. Furthermore, since there was no "sale or exchange" of a capital asset, the gain was taxable as ordinary income and could not qualify as capital gain. *Zobel Estate,* 28 TC No. 97.

OTHER ACCOUNTING DECISIONS

Expenses paid and reimbursements collected should be reported on cash basis. Representation expenses incurred by Foreign Service officers or employees incurred in one calendar year are reimbursed to them in the following year. Officers who report on a cash basis should deduct the expenses incurred by them in a particular year to the extent they exceed the total amount of reimbursement actually received during that year even though the reimbursement relates to expenses of a previous year. *Rev. Rul.* 57-364.

Fraud penalties accrue at time of filing the return [*Acquiescence*]. In determining earnings and profits at the end of a year for purposes of a dividend distribution, an accrual-basis taxpayer must deduct not only the contested deficiencies determined against it for that year but also fraud penalties applicable to a return filed in that year. The fraud penalty accrues when all the facts determining it have occurred; here when the return is filed. *Stein Estate,* 25 TC No. 940, *acq.* IRB 1957-29.

Fraud penalties accrue at time of filing the return. In *Rev. Rul.* 107 (CB 1953-1 178) the IRS held that fraud penalties against a corporation should not be accrued in the determining of earnings and profits available for dividends until the amount is determined finally. In view of the decision in *Stein Estate,* 25 TC 940 [*acq.* noted above.—*Ed.*] the Service revokes *Rev. Rul.* 107 and holds that in determining corporate earnings and profits available for dividends such penalties accrue upon filing the return. *Rev. Rul.* 57-332.

New form for request for change in accounting period. Form 1128 (application for change in accounting period) has been extensively revised. The new form calls for considerable accounting information which previously was required by the IRS in the course of correspondence with the applicant. *Notice* 335.

Loans to insolvent investment counsel not worthless [*Acquiescence*]. Taxpayer lent some $90,000 from 1937 to 1943 to an investment counsel corporation. The corporation operated at a loss and the Commissioner argued the debt was worthless before 1944, the year claimed. The Tax Court disagreed; though the corporation was insolvent it always had some cash and could have paid part of the notes. *Pierson,* 27 TC 330, *acq.,* IRB 1957-21.

No stepped-up basis for gift in contemplation of death (old law). An inter vivos gift was held to have been made in contemplation of death and was included in the gross estate of the donor. The gift property was sold after the donor's death. The court holds that under the 1939 Code, the basis of the property sold was not its value at death (or one year later) but rather the basis in the hands of the donor at the time the gift was made. [Under the 1954 Code, property acquired by a gift in contemplation of death has basis value at date of death or one year later.—*Ed.*] *Spicer,* Ct. Cls., 7/12/57.

"Security deposit" held rent and income to lessor. $16,200 received by a lessor "to be held as security for the payment of rent" is held to be primarily advance payment of rent for the last year of the lease rather than a security deposit for performance. Accordingly the court holds it is includable in the lessor's gross income in the year of receipt. The court notes the following facts: the payment was to be applied to the last year's rent; the lessors were not required to pay any interest on the deposit; the lessors were under no obligation to repay the deposit; the deposit was placed in the lessors' general bank account; there were no restrictions upon the lessors' use of the deposit. *Shaucet,* TCM 1957-133.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

New decision denies surtax credit to subsidiary taking parent's assets

by JOSEPH E. TIERNEY, JR.

Practitioners have been relying on the Tax Court dictum in the Alprosa Watch case to the effect that the penalties of Section 129 apply only to the person acquiring a corporation, not to the corporation acquired. Now a new interpretation by the Fourth Circuit reverses the Tax Court, holding that Section 129 is applicable to an acquired corporation also. Mr. Tierney here discusses the Fourth Circuit's ruling, the scope and application of Section 129 and several illustrative cases.

ONE OF THE most quoted dicta in tax cases is the famous comment of the Tax Court in *Alprosa Watch Corp.* (11 TC 240) that the penalties of Section 129 (Section 269 of the 1954 Code) apply only to the person who acquires a corporation for tax avoidance, not to the corporation acquired. Tax men who read the statute this way took comfort from the Tax Court dictum and were gratified when the court took the same position in another case which turned on that point: *Coastal Oil Storage Co.* (25 TC 1304). Now the Fourth Circuit has reversed the Tax Court on this question (3/11/57). It denied the $25,000 surtax exemption to a subsidiary created to take over certain assets of its parent. Thus the subsidiary lost its tax advantage because of the acquisition for the forbidden purpose by the parent.

Section 1551

At the present time, of course, a subsidiary's right to a surtax exemption, as well as the $60,000 allowable accumulation of earnings, is specifically covered by Section 1551, applicable to 1951 and later years.

Note that Section 1551 does not apply to some fairly common situations—the transferee corporation not "created" to receive the assets[1] or one actively engaged in business at the time of the acquisition of the property. In these situations the Commissioner would be forced to rely on Section 269 and hence its scope is of great importance.

Cautious tax men have long been aware that the *Alprosa* dictum was not universally regarded as correct. Indeed no less an authority than Thomas Tarleau, speaking in 1953 at the 6th Federal Tax Conference of the University of Chicago, warned that the Tax Court's position was unsound. [See box on page 220. *Ed.*]

Section 129(a)(1)

It has been widely asserted that clause (a)(1) would deny benefits only to a corporation which acquired control of another corporation. The Tax Court in *Coastal Oil Storage* adopted that position in holding Section 129 not applicable, and in its opinion used the following language:

"That argument, presumably, is based on the language of clause (1) of Section 129(a) which treats of the acquisition of control of a corporation. It is not an apt argument here, for this petitioner did not acquire control of another corporation."

Mertens Law of Federal Income Taxation reviews the development of this position from its origin in *Alprosa Watch Corp.* Mertens describes the Tax Court's pronouncement in *Alprosa* as ". . . a highly significant dictum," and points out that the Tax Court later affirmed its position in *A. B. & Container Corp.*, (14 TC 842 (1950)) and *Mountain Wholesale Co., Inc.*, (17 TC 870 (1952)). The Tax Court's "highly significant dictum" in *Alprosa* is as follows:

"That Section (129) would seem to prohibit the use of a deduction, credit, or allowance only by the acquiring person or corporation and not their use by the corporation whose control was acquired."

This question was also discussed recently in *The T. V. D. Co.*, (27 TC 108 (2/28/57)). Though the discussion was dicta (the court found no evidence that tax avoidance was a primary motive in the transaction), the court stated its interpretation of the statute: "It is manifest from the unambiguous terms of Section 129 that it applies only to an acquiring corporation and does not apply to an acquired corporation."

The Tax Court took the same position in *Coastal Oil*, and there it met reversal. The taxpayer in *Coastal Oil* was created to receive storage tanks of its parent, not used in the parent's U. S. Government work. The Fourth Circuit said the Tax Court was in error in finding Section 269 inapplicable:

"The Tax Court . . . held the Section inapplicable, without passing on the question as to whether or not tax evasion or avoidance was the principal purpose of the transfer in question. In this we think there was error. It is clear that the parent corporation acquired complete control of taxpayer through stock ownership and the parent corporation was certainly a person within the meaning of subsection (1) of the statute. As a result of the transfer of its property in exchange for the stock, it was able to obtain through this splitting up of its corporate business the benefit of an exemption and credit which it would not otherwise have enjoyed. While the exemption is claimed by taxpayer, the sole benefit thereof would accrue to the parent corporation, the sole owner of its stock. . . . We see no reason, therefore, why subsection (1) of the Section is not applicable."

The decision of the circuit court in *Coastal Oil Storage* in effect ignores the

[1] There is pending in the Tax Court a case involving the applicability of Section 1551 to the original incorporation of a group of related corporations: *Aldon Homes, Inc.*, Docket No. 60020.

corporate existence of the subsidiary in emphasizing that the parent (which is not a party to the tax case) acquired control of the subsidiary and as a result was able to obtain these benefits (surtax exemption and minimum credit) through the splitting of its corporate business. Thus though the subsidiary claims the exemption and credit, the parent (Coastal Oil Terminals, Inc.) obtained the benefit, and this, in the court's view, is sufficient to bring it within 269.

Clause (a)(2)

The Tax Court had held that *Coastal Oil* came within neither clause of 269—not (a)(1) because the credit at issue was its "own" credit, nor (a)(2) because there was no relation between the property acquired and the credit. The acquisition of the storage tanks did not, the Tax Court said, secure for it ". . . the benefit of any deduction, credit or other allowance which such person would not otherwise enjoy. . . ." The court pointed out that it had held in *Commodores Point Terminal Corp.* (11 TC 411 (1948)) that the word "otherwise" can only be interpreted to mean that the deduction, credit or allowance must stem from the acquisition if it is to be disallowed. The court went on to point out that the storage tanks acquired by Coastal Terminals, Inc. "did not carry with them a right to an exemption or credit."

Fourth Circuit reverses

The Fourth Circuit disagreed, noting that neither the taxpayer nor its parent would have been entitled to the exemption and the credit without the transfer of the property. Therefore, there were benefits not otherwise enjoyed. The court explains that conclusion by this statement: ". . . for the taxpayer (Storage) could not have *enjoyed* the benefit of the surtax exemption and excess profits tax credit but for the acquisition of the property producing the income from or against which the exemption and credit are claimed." [Emphasis supplied.] . . . It will be noted that again the Fourth Circuit minimizes the corporate existence of the subsidiary, and applies the statutory language relating to "a benefit otherwise enjoyed" to both corporations.

The opinion of the circuit court quotes a paragraph from a Senate report to show that Sections 45 and 129 were intended to prevent tax avoidance by the splitting up of business enterprises to utilize extra surtax exemptions. . . . That the Section was intended to reach just such schemes for tax evasion or avoidance by the splitting up of a business enterprise clearly appears from the H. Rep. No. 871, 78th Cong. 1st Sess. p. 49, where it said:

"This Section adds a new Section 129 to Chapter 1 of the Code providing that in the case of acquisitions on or after October 8, 1940, of an interest in or control of corporations or property which the Commissioner finds to be principally motivated by or availed of for the avoidance of income or excess profits tax by securing the benefit of a deduction, credit, or other allowance, then the tax benefits are to be disallowed or allowed only in part in a manner consistent with the prevention of tax avoidance. This Section is designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.

"The crux of the devices which have come to the attention of your committee has been some form of acquisition on or after the effective date of the Second Revenue Act of 1940, but the devices take many forms. Thus, the acquisition may be an acquisition of the shares of a corporation, or it may be an acquisition which follows by operation of law in the case of a corporation resulting from a statutory merger or consolidation. The person, or persons, making the acquisition likewise vary, as do the forms or methods of utilization under which tax avoidance is sought. Likewise, the tax benefits sought may be one or more of several deductions or credits, including the utilization of excess profits credits, carry-overs and carry-backs of losses or unused excess profits credits, and anticipated expense of other deductions. In the light of these considerations, the Section has not confined itself to a description of any particular methods for carrying out such tax avoidance schemes but has included within its scope these devices in whatever form they may appear. *For similar reasons,*

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TEXT OF SECTIONS 1551 AND 269(a)

SECTION 1551 provides that "if any corporation transfers . . . all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation . . . then such transferee corporation shall not . . . be allowed either the $25,000 exemption from surtax . . . or the $60,000 accumulated earnings credit . . . unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this Section, control means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of the corporation."

Section 269(a) (which is identical with Section 129(a) of the 1939 Code) provides that "If—

1. any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

2. any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of the corporation."

MR. TARLEAU'S WARNING

THE STAND of the Tax Court in *Alprosa Watch* was a misreading of the statute and thwarted the expressed intention of Congress, in the view of Thomas N. Tarleau, well-known New York lawyer. At the University of Chicago's Tax Conference held in 1953, Mr Tarleau said:

"Turning from the words of the statute, and of the Congressional committee report, to the *Alprosa Watch* dictum is indeed astounding. If the Tax Court is correct, Section 129 is practically meaningless. The dictum suggests that the continuity of a corporate shell, the merest fiction, is enough to eliminate any consideration whatsoever of the reality of the acquisition, the depth of the tax avoidance motive, the extent to which the avenue chosen by the taxpayer is germane to any venture at hand . . . . The *Alprosa Watch* dictum is flatly contrary to the intent of Congress in passing Section 129. The Senate committee report said:

'Section 129, under your committee's amendment, as under the House bill, recognizes that any attempt to encompass tax evasion and avoidance problems by a specific description of the tax avoidance schemes will catch within its net both intended transactions and those not intended and will fail to catch both those intended to be caught and those not intended. Further, the specific description tends to center attention upon the form and technical character of the scheme, and to let the substance of the tax avoidance escape. To determine what transactions constitute the condemned evasion or avoidance, Section 129 must be read in its context and background. It is superimposed on the several existing provisions of the income and excess profits tax law, the basic policies of which contemplate the bona fide conduct of business in the ordinary way. Basic to the deduction, credit, and allowance provisions is a continuing enterprise so conducting its affairs. . . .' "

Alprosa dictum perilous

Mr. Tarleau continued that neither the statute or its history "justify the interpretation. Taxpayers may certainly acquire control of a corporation to get the benefit of the corporation's carryovers. To hold that the shareholders of a corporation do not 'enjoy' its tax losses when they put a profitable business into it, is wrong. The dictum appears to have been conceived with the idea that the carryover, credit, or other allowance, must itself have been acquired directly by the new group for Section 129 to apply. But the statute refers only to acquisition of the control of corporations, or of property. In short, the *Alprosa Watch* dictum is not justified by the words or the purpose of Section 129, and taxpayers rely on it at their peril. . . .

"It is hard to account for the continued currency of the dictum in the *Alprosa Watch* case in view of the plain language of the statute. Two things may be suggested. The first is the undeniable fact that the Government has lost all of the litigated Section 129 cases. The decisions have been solely on the basis of business purpose, but the uninterrupted line of decisions has perhaps misled people into thinking there is some fatal flaw in Section 129 as a matter of law.

"The second notion that comes to mind is that there exists a confusion between the kind of situation which existed in *Alprosa Watch* and the *A. B. & Container* cases, and another common situation which is not covered by Section 129. That is the case of a corporation with past losses or with unused excess profits tax credit which goes out and acquires a new, profitable business in the same or another line. It does not seem that Section 129 would operate to deprive the shareholders, who had suffered losses through their company, of the opportunity to offset those losses by finding new ways to make profits. The connection between the shareholders and the advantageous tax allowance is not sham or artificial. The acquisition of the profitable enterprise is 'germane' to their venture . . . The reason why Section 129 does not condemn this latter type of acquisition is not, as the Tax Court suggested in the *Alprosa Watch* case, that the action does not impinge upon the enjoyment by a corporation of 'its own' loss, but rather that the recoupment of a loss by the expansion or change of an unsuccessful business is a legitimate business purpose and one which the loss carryover position is intended to assist."

the scope of the terms used in the Section is to be found in the objective of the Section, namely, to prevent the tax liability from being reduced through the distortion or perversion effected through tax avoidance devices. . . .! (Italics supplied).

"This accords with the interpretation placed upon the Section by a later Congress, where in the Senate report on proposed amendments to the corporate surtax exemption provisions, it was said (S. Rep. No. 2375, 81st Cong. 2d Sess. p. 70, 2 Cum. Bull. 483, 533):

'It is not intended, however, that the exemption of the first $25,000 of a corporation's surtax net income from the surtax shall be abused by the splitting up, directly or indirectly, of a business enterprise into two or more corporations or the forming of two or more corporations to carry on an integrated business enterprise. It is believed that Sections 45 and 129 will prevent this form of tax avoidance.' "

Based on that intention of Congress, the circuit court concludes that Section 129 was specifically directed at the type of transaction entered into by Coastal Oil Terminals and Coastal Oil Storage. ☆

Operational problems in mergers and acquisitions

TAX MEN working with mergers and acquisitions can get a lot of valuable non-tax help on problems arising in the course of such negotiations from three monographs just released by the American Management Association. While ordinarily we are concerned with tax considerations, no tax advisor can do a really first-rate job without paying attention to broader operational and management problems. These new publications are:

Legal, Financial, and Tax Aspects of Mergers and Acquisitions, 90 pp., contains eight articles on various phases of financing mergers.

A Case Study in Corporate Acquisition, 42 pp., a detailed account of the development of the acquisition of W-K-W Company by ACF Industries, Inc.

Integrated Policies and Problems in Mergers and Acquisitions, 67 pp., seven articles on how to make the merged organization function well.

All these are available from AMA, 1515 Broadway, New York 36; price is $1.75 each. ☆

Rulings point to exemption of 306 stock in public companies as IRS policy

by **ALGER B. CHAPMAN**

When Congress put Section 306 into the Code to block preferred stock bailouts by making a gain on the sale of such stock ordinary income, it also put in a safety valve—an authorization to the Commissioner to exempt 306 stock from this treatment on sales whenever he is satisfied that tax avoidance is not a principal purpose of the issue and disposition. The Regulations gave no clue as to how the IRS would exercise this discretion. However, three rulings (see box) that have come down mark out one area in which IRS policy apparently has been formed. Mr. Chapman analyzes these rulings, all dealing with 306 stock in publicly held companies, points out the apparent rationale of the IRS and warns of the questions on which no position has yet been taken publicly by the Service.

SECTION 306(b)(4) leaves the door open for the Commissioner to exempt from the thrust of Section 306 that great majority of dispositions where tax avoidance is not a motivating factor. Under the ruling policy as it is now evolving, Section 306(b)(4) may virtually remove publicly held corporations from the scope of Section 306.

The Regulations promulgated under Section 306(b)(4) do not shed much light on the circumstances under which the ruling power conferred thereby is to be exercised. As a matter of fact, the single illustration[1] contained in the Regulations would appear to indicate a rather sparing application of such power. This intentionally vague and narrow example was promulgated before the Service had had an opportunity to acquire experience in dealing with this provision. The Service was holding open the possibility of a highly restricted application of the exception in the future if deemed appropriate.

To date, the three published rulings on this subject make it clear that the Service has wisely forsaken such a limited view of the matter and is prepared to exercise its discretion liberally in favor of preferred stock issues of publicly held corporations where the stock is issued pursuant to a bona fide business purpose.

The first of these rulings, *Rev. Rul.* 56-116, Cum. Bull. 1956-1, p. 6, considered the problem of preferred stock issued in connection with the merger of two publicly held corporations. The shareholders of "Y" (the disappearing) Corporation, in exchange for their common stock, received both preferred and common stock of "X" (the surviving) Corporation and after the merger, the total percentage of stock of "X" Corporation held by the former shareholders of "Y" corporation was less than 20%. The preferred stock was issued to the shareholders of "Y" corporation in lieu of additional common stock at the insistence of the survivor. The ruling states that the former "X" had shown more dynamic growth over the last several years and it "desired to limit the extent to which the stockholders of "Y" Corporation may share in the future growth of the common equity." It was further stated that "X" company had no intention of redeeming any of the preferred stock except pursuant to the provisions of the purchase fund and sinking fund agreements, the terms of which are not set forth in the ruling and which are stated to be irrelevant. The Service held in this situation that the preferred stock clearly constituted Section 306 stock within the meaning of Section 306(c)(1) received in pursuance of a plan or reorganization, the effect of the transaction being substantially the same as the receipt of a stock dividend. However, the Service ruled:

"It is further held that the provisions of Section 306(a)(1) of the 1954 Code shall not be applicable to the proceeds of the disposition of the preferred stock of "X" which will be issued in the merger, unless such disposition is in anticipation of a redemption after the issuance of the stock. See Section 1.306-2(b)(3) of the Regulations under Subchapter C, Treasury Decision 6152."

The limitations of this ruling should be carefully observed. First, and most important, it is restricted to the provisions of Section 306(a)(1) which deals with dispositions other than redemptions. No protection is offered in this ruling with respect to the subsequent redemption of the stock. Apparently, the Service was willing to concede in such a situation that the distribution of the preferred stock was not in pursuance of a plan of tax avoidance and that a subsequent sale of such stock would not be pursuant to such a plan. However, it was not willing to state that a subsequent redemption was not in pursuance of a tax avoidance plan. This conclusion would appear to have been reached regardless of whether the redemption was pursuant to the provisions of the sinking fund agreement or not. The basis of this distinction between subsequent sale or redemption does not appear to be one of substantive law but rather one of Service policy. From a substantive point of view, if the distribution and *sale* of the stock are not in pursuance of a tax avoidance plan it would seem hard to find such a plan where there is a distribution and *redemption*, particularly when it is not known at the time of the ruling whether the preferred stock will be sold or redeemed. One would assume that an avoidance plan, if any, would be formulated prior to the distribution. Once having cleared the distribution, it seems hardly tenable to rule that there may still be a plan of tax avoidance encompassing the distribution and the redemption.

What the Service appears to be saying in this first ruling is that any determination with respect to a redemption question is premature. No specific redemption having been proposed or intended when the application for ruling was presented, the Service exercised its prerogative of refraining from ruling on what might be a purely hypothetical case.

Such a policy would hardly be logical, since a future disposition by sale would appear to be similarly hypothetical. The real distinction may lie in the fact that a sale of widely held preferred stock does not give rise to the withdrawal of earnings and profits from the corporation at capital gain rates and that the bailout possibilities are only present

[1] 1.306-2(b)(3).

STRUCTURE OF SECTION 306

SECTION 306(a) sets forth the general rule that the profit received from the sale or other disposition of "Section 306 stock" shall be treated as gain from the sale of property which is not a capital asset, except that if the disposition is in the form of a redemption, then such profit shall be treated as a corporate distribution to which Section 301 applies. Section 306(c) defines Section 306 stock to include not only non-taxable preferred stock dividends, but also preferred stock received in pursuance of a plan of reorganization, or in a Section 355 transaction, with respect to which gain or loss was to any extent not recognized by the receiving stockholder and where the effect of the transaction was substantially the same as the receipt of the stock dividend.

In general, therefore, the section would tax as ordinary income the amounts realized from the disposition or redemption of preferred stock issued as a non-taxable stock dividend or received in one of the specified non-taxable exchanges or distributions. These sweeping provisions are subject, however, to four exceptions set forth in Section 306(b). The first three include dispositions or redemptions which completely terminate the interest of the selling shareholder, distributions in partial or complete liquidation, or dispositions of Section 306 stock in conjunction with further non-taxable transactions. The applicability of these exceptions, while reasonably broad, do little or nothing for the typical Section 306 stockholder desiring to dispose of his preferred stock interest in a going concern. However, the fourth exception, Section 306(b)(4), reads as follows: "If it is established to the satisfaction of the Secretary or his delegate—(A) that the distribution, and the disposition or redemption, or (B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the Section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the Section 306 stock, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." ☆

with respect to redemptions. Accordingly, by withholding its discretionary approval the Service tends to discourage redemptions. In any event, the Service made this limitation in its initial published ruling and is still adhering to this policy.

One should note that, in clearing the distribution and sale aspects of the proposed transaction, the Service took care to state the business purpose of the preferred stock, to wit: the arm's length negotiations of the merger agreement, the more dynamic growth of one corporation and the insistence by it on limiting the shareholders of the other in their participation in the equity of the merged company. Naturally, this is only an example of the type of business purpose which the Service will recognize in a situation of this kind. In general, some economic justification for the use of preferred stock must be present to avoid the possible inference that a principal purpose of its issue was to bail out earnings and profits at capital gain rates.

The exemption of the sale of Section 306 stock from the provisions of Section 306(a)(1) was restricted to the situation where the sale was not in anticipation of a redemption after the issuance of the stock. Perhaps the clause in the ruling dealing with this restriction would have more accurately reflected the Service's intent if it had read "unless such disposition is in anticipation of a redemption shortly after the issuance of the stock." As brought out by a later ruling (*Rev. Rul.* 57-212, discussed *infra*), the Service is interested only in protecting the revenues against a prearranged quick two-step sale and redemption and is not directing its fire at a sale which may anticipate a redemption several years after the merger.

One public; one closely held

The second published ruling on this problem was *Rev. Rul.* 57-103, IRB 1957-11. This ruling, which apparently goes far beyond the position of the IRS as expressed in *Rev. Rul.* 56-116, has caused considerable comment and should be approached with utmost caution. The ruling involved the acquisition, by a publicly held corporation for bona fide business reasons, of the assets of a closely held corporation in return for voting preferred and common stock of the acquiring corporation pursuant to a tax free reorganization under Section 368(a)(1)(C). The shareholders of the closely held corporation were the owners of 5% of the outstanding stock of the acquiring corporation after the reorganization. The Service held that although the preferred stock in the transaction constituted Section 306 stock its issuance was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax and therefore that— ". . . the provisions of Section 306(a) of the Code, . . . will not be applicable to the disposition of any portion of the preferred stock. See *Rev. Rul.* 56-116. . . ."

This holding appears to be much broader than *Rev. Rul.* 56-116 in at least two particulars. First, it applies to Section 306(a) as a whole and is not restricted merely to the provisions of Section 306(a)(1) which deals with dispositions other than redemptions. Second, with respect to distributions other than redemptions, it contains no qualification that the disposition not be in anticipation of a redemption. The implication to be derived from this ruling would seem to be that the Service has given a green light to *all* distributions of Section 306 stock by publicly held corporations provided that there are bona fide business reasons for the issuance. However, the current ruling practice of the Service indicates that this is clearly not the case. The language of this published ruling goes beyond what the Service is prepared to grant in unpublished or private rulings. *Rev. Rul.* 57-103 was intended primarily to extend the rule of 56-116 to a situation involving a publicly held corporation and a closely held corporation as compared to the factual situation in 56-116 which involved two publicly held corporations. This in itself is a valuable extension from a taxpayer's point of view, as one could not automatically assume that the conversion of common stock of a closely held corporation into common and preferred stock of a publicly held corporation would necessarily be held free of the purpose to bail out earnings and profits.

Accordingly, *Rev. Rul.* 57-103 should not be read as giving a green light to the redemption of Section 306 stock

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prior to the time an actual redemption is proposed. The Service still views such a question as prematurely raised. The absence of language indicating that the disposition must not be in anticipation of a redemption can perhaps be explained on the grounds that the Service deemed such a condition implied by its citation of *Rev. Rul.* 56-116 at the end of the ruling.

Preferred to be redeemed

The third and latest ruling on the subject, *Rev. Rul.* 57-212, IRB 1957-21, p. 14, helps to clear up some of the uncertainties caused by *Rev. Rul.* 57-103. Significantly, this ruling cites only *Rev. Rul.* 56-116 as supporting authority and omits any reference to *Rev. Rul.* 57-103. *Rev. Rul.* 57-212 deals with a merger in which the stockholders of the transferor corporation received common and preferred stock in the surviving corporation. The merger agreement provided for a sinking fund pursuant to which the surviving corporation is required to set aside annually amounts equal to 3% of the aggregate par value of the preferred stock outstanding. These amounts were to be applied for the purchase of the preferred stock either in the open market or to the redemption by lot of sufficient preferred shares to satisfy the sinking fund requirements.

The Service ruled in this situation that neither the merger distribution nor the subsequent redemption is in pursuance of a plan of tax avoidance within the meaning of Section 306(b)(4). It held that Section 306(a)(1) will not be applicable to the proceeds of the sale of such shares (whether or not in anticipation of a redemption through the operation of the sinking fund) and that Section 306(a)(2) will not be applicable to amounts distributed in redemption pursuant to the sinking fund provisions.

This ruling, unlike the two prior rulings, was issued subsequent to the consummation of the merger. The Service no longer withheld its approval of the redemption plan as prematurely presented but agreed to rule on it in view of the fact that an actual redemption under the sinking fund was about to be made or had already been made. The Service thus indicated that where the redemption is undertaken in orderly fashion, such redemption will be exempted from Section 306(a)(2) if a request for ruling is presented at the proper time. This should certainly embolden taxpayers who have previously hesitated about proceeding with a preferred stock distribution without a Section 306(a)(2) ruling. *Rev. Rul.* 56-116 and *Rev Rul.* 57-212, read together, may add up to adequate assurance on this point.

In this published ruling, the Service took the opportunity to clarify a point that had been left in doubt by *Rev. Rul.* 56-116. Its approval of the sale of the preferred shares is no longer conditioned on such sale not being in anticipation of redemption. The Service expresses no objection to a sale made in anticipation of a redemption through the ordinary operation of the sinking fund. Its earlier qualification of this character was addressed solely to sales made in anticipation of a redemption shortly after the merger which would be presumed to be pursuant to a plan of tax avoidance.

Rev. Rul. 57-212 makes no specific mention of the business purpose for the issuance of the preferred stock nor does it include any reference to the percentage of the stock of the surviving corporation to be held by the stockholders of the transferor corporation. This should not be construed as meaning that these factors are no longer of importance. The Service will still look for a valid business purpose in determining the presence or absence of a plan of tax avoidance and will also take into account whether or not the stockholders receiving preferred stock will have a controlling voice in the affairs of the corporation so that they will be able to bring about a redemption of their shares at their pleasure.

In summary, a ruling policy under Section 306(b)(4) is evolving which quite properly looks with favor on transactions involving publicly-held corporations. The definite tendency is to treat publicly-held corporations with great liberality where an adequate business reason for the issuance of the preferred stock can be shown. The Service is still requiring, in its ruling policy, the taxpayer to take two bites at the apple; the first bite to cover the distribution and sale of Section 306 stock and the second bite to cover the redemption as it occurs. It is very possible that with the passage of time the Service may get to the point where it will give clearance prior to the distribution not only to sales but to redemptions carried out pursuant to mandatory sinking fund provisions, particularly where redemptions can not commence under the terms of the sinking fund for some period of years after the merger and where the redemptions are by lot.

Where the redemption is carried out other than through sinking fund pro-

THE THREE RULINGS ON 306(b)(4)

June, 1956: Under a plan of merger of two publicly held corporations, the surviving corporation issued preferred and common stock to the common stockholders of the merged corporations. The preferred stock received in connection with the merger is "Section 306 stock." However, the provisions of Section 306(a)(1) treating the gain on disposition of such stock as ordinary income are held not applicable; there was good business reason for the issuance. The earnings of the merged company were stable but low. The preferred was used to limit the participation of its stockholders in the combined earnings. For this reason the distribution is not in pursuance of a plan of tax avoidance. *Rev. Rul.* 56-116.

March, 1957: A publicly held corporation for bona fide business reasons acquired, in a nontaxable reorganization, all the assets of a closely held corporation with only common stock in return for 5% of its outstanding voting preferred and common. The Service holds that the preferred constitutes Section 306 stock. However, gain or loss on its sale or other disposition will not be treated as ordinary income since the issuance was not in pursuance of a tax-avoidance plan. *Rev. Rul.* 57-103.

May, 1957: Preferred shares had been issued in a nontaxable merger of two large publicly owned corporations (it was Section 306 stock). The corporation is required to redeem 3% of the shares annually. The Service holds that the redemption of preferred comes within the exception provided by Section 306 (b)(4); the Commissioner is satisfied that the redemption is not in pursuance of a plan having as one of its principal purposes the avoidance of income taxes. *Rev. Rul.* 57-212.

visions, it seems safe to predict that the Service will not, in the near future, rule on the applicability of Section 306(b)(4) until such redemptions are actually being proposed. Among the standards by which such redemptions would be judged would be the degree of control over the corporation's affairs exercised by the redeeming shareholders, the length of time that has elapsed since the date of distribution, the business purpose of the redemption and such factors as might be properly taken into account in determining whether distribution was essentially equivalent to a taxable dividend under Section 302 (b)(1). ☆

[*The foregoing is adapted from an article published in The Tax Executive, used here with permission.*]

Tax free dividends from fast writeoffs are under scrutiny

ONE OF THE MAJOR effects of fast amortization is the generation of additional cash available for working capital or plant expansion. Another intriguing and desirable use for the extra cash is the distribution of tax free dividends. It is not unusual for the rapid amortization deduction to completely wipe out current profits, but the cash is still available for distributions to stockholders. It is more common for the deduction to reduce the earnings and profits to a point lower than the amounts distributed to the shareholders, and the excess is then treated as a tax free return of capital, and reduction of basis under Section 301(c)(2) of the Code.

Thus, if South Nevada Utilities earns $2 per share before the amortization deduction of 75c per share, and distributes $1.75 to its shareholders, the 50c excess over current earnings of $1.25 per share will be a tax free distribution. This result can be accomplished, of course, only if the Company has no accumulated earnings and profits, since a dividend is taxable under Section 316 whether distributed out of current earnings or earnings accumulated in prior years.

The tax appeal of a dividend either wholly or partially free of income tax to the stockholder is a very real thing in today's market. Where the cash is generated by fast amortization and has not been subject to immediate tax, the corporation is also the beneficiary since it may plow back more into plant expansion, increase its working capital and distribute larger dividends. Thus, the company grows faster and its stock is more valuable.

While not limited to any particular industry, it appears that utilities have been especially cognizant of the advantages of distributing tax free dividends stemming from fast amortization. Utilities have long been noted for an extremely high dividend pay-out, and the ratio of dividends to earnings frequently runs as high as 75%, as contrasted to a ratio of 50 to 55% in industrial corporations. Thus, a rapid amortization deduction can easily run the pay-out ratio over 100% and produce a tax free dividend as to the excess.

This favorable dividend climate now appears a bit cloudy as a result of hearings before a Senate Judiciary Subcommittee. Senator Kefauver has demanded that the Administration or Congress call a stop to what he terms "bonanza" tax free dividends stemming from fast amortization writeoffs. The impact of the hearings is described in a recent issue of *The Wall Street Journal* (July 31, 1957).

Mr. Kefauver was chiefly concerned with fast writeoffs—and subsequently tax free dividends—in the electric power industry. But the issue is one that cuts across many other industries that have received special tax aid under a program started during the Korean War to spur expansion of defense-essential facilities.

"A company getting a fast writeoff certificate is allowed to depreciate for tax purposes a big portion of the cost of a new plant in five years instead of the regular period, running as high as 50 years in some cases. This means the firm pays less tax than would otherwise be required during the first five years but—assuming no change in tax rates—pays greater-than-normal taxes in following years to make up for it.

"Under present tax laws, if a stockholder receives a dividend that represents a distribution by the corporation out of current or accumulated earnings, this dividend is considered income and he must pay a tax at the applicable income tax rate. But payments in excess of current or accumulated earnings are considered a taxfree return of capital, not income. Many companies can generate excess cash for distribution because fast writeoffs, by enlarging depreciation deductions, shrink or even eliminate income subject to tax. They can plow back this extra cash into the company or distribute this extra money as a tax free return of capital.

"Sen. Kefauver said, 'I make no suggestion of irregularity in commenting on these distributions,' but said the subcommittee wants to determine whether such a policy of special tax aid is desirable.

"William W. Gatchell, general counsel of the Federal Power Commission, also assumed the tax free distributions were legal, but said his agency will explore the whole subject. He said these tax free dividends were 'an unintended benefit' of the fast writeoff program."

With both a Senate Subcommittee and the Federal Power Commission working on the problem, we wonder if the Treasury Department will turn its legislative watch dogs and draftsmen loose on the problem. While it poses one more concern for the cautious tax man, he at least may continue to advise that under the present law a tax free dividend arising from rapid amortization is a permissible and accepted practice. ☆

New corporate decisions this month

Debt-to-capital ratio of 600 to 1 too thin [*Certiorari denied*]. Taxpayer-corporation was organized by five individuals to acquire title to and operate rental property. Of the $150,000 required over and above the mortgages to purchase the properties, $3,000 was received for stock and $147,000 as advances from the stockholders in amounts proportionate to their equities. Additional sums were later advanced in like proportions as working capital. No written notes were issued to evidence the advances and no fixed date of repayment was specified. The Tax Court noted that the ratio of debt to capital was 600 to 1, and refused to permit a deduction for the amounts accrued as interest on these

purported loans. The Second Circuit affirmed. 241 *Corp., Cert. den.*, 6/24/57.

Return on stock not deductible as interest. The Tax Court held that a 5% return on "preferred stock" carried on the books as capital stock is a dividend and not interest paid on borrowed capital. Taxpayer argued that the preferred was in reality a debt, not equity, called stock only to avoid a liability on the balance sheet. The Tax Court referred to the fact that the parties called it stock as a "determining factor." In addition, the dividends on the preferred were payable from earnings and on liquidation the claims of preferred stockholders would be junior to the claims of creditors. The circuit court affirms. *Crown Iron Works*, CA-8, 6/24/

Stockholder has non-business debt on loan to his corporation. Since 1930, taxpayer had been a distributor of film and audio visual equipment. However, his loans to the three corporations through which he carried on the film business did not amount to the business of being a financier. Losses incurred when he had to pay bank loans of one corporation he had guaranteed are therefore non-business, treated by law as a short-term capital loss. *Holtz*, TCM 1957-106.

Stockholder's loans to corporation non-business. Taxpayer had purchased various food companies and combined them into one organization in which he and his brother owned 44%; the rest was publicly held. Thereafter, he bought another which failed. He claimed the money he advanced to it was a business bad debt. The court disagreed. Taxpayer's activities did not amount to the business of financing companies. He was in the food business, not the money-lending business. *Jennings*, TCM 1957-104.

Liquor salesman's loss on "bottle club" non-business. For two years taxpayer, an employee of several bottle clubs, rented a building and furniture to one. These clubs were organized under Washington law to provide members with liquor storage space and facilities for consumption. Due to a change in the law, the club itself was required to own its facilities and taxpayer sold them to it for its notes. They became worthless and he claimed a business bad debt. He was, in the year of worthlessness, a salesman for a liquor importer. The court holds the loss is non-business. The investment in club facilities and the loss bore no proximate relation to his employment by either the bottle club or the liquor importer. *Edmonds*, TCM 1957-97.

Jury finds taxpayer in business of financing enterprises; bad debt loss allowed. The jury finds that during the taxable year the taxpayer was in the business of organizing and financing business enterprises. Accordingly, the loss on a loan to one corporation is an ordinary bad debt loss. No facts are given. *Tellepsen*, DC Tex., 6/21/57.

Administrative fees charged by affiliate allowed as reasonable [*Acquiescence*]. From the time of its formation in 1944 until 1947, taxpayer-corporation operated with a skeleton crew. A company which owned 50% of taxpayer's stock furnished staff, management, and a wide variety of services to or for its benefit. Payment by taxpayer to the company of administrative fees ($714,000 over the three-year period) is allowed as reasonable in view of the services performed, notwithstanding that the sum was arrived at in negotiations that were not conducted at armslength. *Waring Products Corp.*, 27 TC No. 114, *acq.* IRB 1957-29.

Rent to stockholder for his property found reasonable. Taxpayer corporation was owned by its chief executive (60%), his wife (20%) and his brother (20%). The controlling stockholder and his wife owned real estate occupied by the business. On the basis of testimony of a real estate appraiser, the court finds the rental was reasonable. The court also found that the rental arrangements between taxpayer, the stockholders and another corporation controlled by the stockholders was proper; it was in accord with an oral modification of the written lease. *Ross Auto Parts*, TCM 1957-120.

Court of Appeals reverses Tax Court and Commissioner on allocating income between affiliates. Taxpayer corporation was an auto dealer handling Ford cars in one division and Lincoln and Mercury in another. Its stockholders (father and sons) were also members of a partnership handling tractors and during the war years, engaging in some other ventures. From 1939 to 1945, it was under contract with the auto corporation to finance the corporation's auto sales. In 1946, when the auto business, almost nonexistent during the war, revived, the corporation was split into two (one for each division). The partnership agreed to serve the new corporations in the same way. 1949 is the year here in issue. The Tax Court held that the partnership functioned only to purchase the sales contracts and transfer them to the finance companies with which the corporation had previously dealt and was a sham to divert corporation income to the stockholders. This court reverses. The partnership business was real; in several years it sustained losses. One dissent: the Commissioner's determination, sustained by the Tax Court, is entitled to great respect. It was not arbitrary or unreasonable. *Raymond Pearson Motor Co.*, CA-5, 6/28/57.

Royalty to stockholder allowed despite previous royalty-free license [*Acquiescence*]. Taxpayer's controlling stockholders had previously granted taxpayer a royalty-free license to use their invention. Subsequently, the agreement was modified to reflect their understanding that royalties would be paid after the value of the process was established. The Tax Court allowed deduction of royalties paid under this modified agreement. *Heatbath Corp.*, 14 TC 332, *acq.* IRB 1957-23, *non-acq.* withdrawn.

TAXABLE AND TAX FREE EXCHANGE

Exchange tax-free despite liquidation step. Under the 1939 Code, the Service had ruled (*Rev. Rul.* 54-396) that a "C" reorganization (voting stock for properties) did not include the acquisition by a 79% stockholder of all the assets of its subsidiary. The reason was that only 21% of the assets was received through an exchange of stock; 79% was received in liquidation. The question now asked is whether this rule will be applied in a type of C reorganization new under the 1954 Code—properties for its parent's voting stock. The particular situation ruled on was the transformation of a 72%-owned subsidiary (the other 28% was widely held) into a 100%-owned subsidiary with the outside stockholders receiving additional stock of the parent. The mechanism used was (1) creation of a new subsidiary by the parent which acquired all the subsidiary stock for some of its own stock; (2) the exchange of all the assets of the existing 72%-

owned subsidiary for the parent's stock held by the new subsidiary; (3) the distribution by the old subsidiary of the parent's stock to its stockholders; and (4) the dissolution of the old subsidiary. While step three might be regarded as a liquidation to which the rationale of 54-396 might be applied, the IRS points out that the entire transaction might have been effected by a "B" reorganization—an exchange of its own stock for the publicly-held stock. The IRS holds that 54-396 will be restricted to cases in which assets transferred are received in liquidation. *Rev. Rul.* 57-278.

Sale to controlled corporation recognized though 2 days after stock issuance [*Acquiescence*]. Partners engaged in logging, milling and marketing of lumber transferred part of the partnership assets to a new corporation on December 31, 1946 in return for stock. Two days later they transferred the remaining partnership assets to the corporation under a ten-year installment-sales contract. The court holds that the sales contract was separate and distinct from the incorporation; that it was not a "security" received in exchange for property, and that gain was recognized on the transfer. Accordingly, the basis for depreciation of assets acquired under the contract was their cost to the company. *Brown*, 27 TC 27, *acq.* IRB 1957-29.

No stepped-up basis on liquidation of subsidiary despite recent issue of additional shares. The 1954 Code adopted the Kimball-Diamond rule and provides (Section 334(b)(2)) that in certain liquidations of 80%-owned subsidiaries within a short time of acquisition the basis to the parent of the assets received shall be its basis for the stock; ordinarily on liquidation of a subsidiary the parent takes the subsidiary's basis for the assets. The IRS now considers the liquidation of a subsidiary which had always been wholly owned. However within the time specified by 334(b)(2) the parent had exchanged certain notes of the subsidiary for additional shares of stock, which new shares were more than 80% of the total outstanding. The IRS rules that this acquisition of 80% is not such a "purchase" as will bring the parent within the rule of 334(b)(2). It must use the subsidiary's basis for the assets. *Rev. Rul.* 57-296.

Spinoff tax free though done as redemption and stockholder investment. The Service holds that the series of transaction whereby a corporation transferred one business (worth about 14% of its total equity) to a 14% stockholder who gave up his interest in the corporation, was a tax free spinoff. The corporation operated two separate businesses in two different cities. The transfer of one was carried out by a redemption of this stockholder's shares of the business for cash; this cash was immediately invested in a new corporation. The remaining assets of the business were transferred, for no consideration, to this new corporation. The effect was a spinoff of one of two active businesses, for the stockholder's stock, followed by the incorporation of that spunoff business by him *Rev. Rul.* 57-311.

Can carry back unused EPT credit to pre-merger year [*Certiorari denied*]. Shortly after its organization, taxpayer was merged with an existing company and its subsidiaries. It claimed the right to carry back an unused excess profits credit to offset income of the original companies and subsidiaries prior to merger. The Court of Claims permitted this; the language of the statute defining acquiring corporations and credits clearly permits it and that result is in accord with *Stanton Brewing*, 176 F.2d 573, which allowed the surviving company in a merger to use the EPT credit unused by a component. *Koppers, cert. den.*, 6/3/57.

LIQUIDATIONS

50% stockholder, paying full corporate tax as transferee, has bad debt loss for other stockholder's share. Taxpayer and another were 50% stockholders in a corporation which liquidated. Taxpayer had previously paid $40,000 of back corporate income taxes, and in this year paid some $4,700 more. The court finds the records not adequate to upset the Commissioner's finding that half of the $4,700 was paid on behalf of the other stockholder. Since that stockholder was insolvent, taxpayer has a non-business bad debt (a short-term capital loss) for that amount. Of the balance, the portion allocable to interest is fully deductible but that which represents additional corporate tax is a liquidation item and a long-term capital loss. *Gersten*, 28 TC No. 84.

Contracts for future payments, distributed in liquidation, valued. Taxpayers were stockholders of a corporation which had paid to a water company the cost of constructing mains to a new development. The utility agreed to pay it a part of water charges to home owners in the development for ten years or until the corporation recovered its cost. The contracts were distributed to taxpayers on liquidation of the corporation. They argued that it would be impossible to value the contracts and that collection should be treated as capital gain as received. The court finds, however, that they can be valued; experts testified that similar contracts are commonly bought and sold. The court sustains the Commissioner's valuation at 50% of the cost not yet repaid. *Gersten*, 28 TC No. 84.

Loss on exchange of property for own stock deductible [*Acquiescence*]. Taxpayer-corporation, an auto agency, transferred a building to one of its stockholders in exchange for $50,000 in cash plus its own stock valued at $125,000. The court holds the transfer of the building was not in partial liquidation because there was no contraction of the business. It was a sale of property having a cost basis of $182,500 for $175,000. The corporation therefore sustained a deductible loss of $7,500. *Johnson-McReynolds Chevrolet Corp.*, 27 TC 300, *acq.* IRB 1957-29.

Vacant land leased to used car dealer not a separate business of food brokerage corporation, distribution not a partial liquidation. In addition to the five-year active business rules applicable to the distribution of stock of a controlled corporation (Section 351) there are somewhat similar rules in the definition of partial liquidation (Section 346) and applicable therefore to the distribution of property, not necessarily stock. The IRS interpreted them in a Ruling dealing with the distribution by a wholly owned corporation, in the food brokerage business for fifty years, of a small parcel of real estate. The real estate was a lot adjacent to a vacant lot, purchased in 1949 but only partly used for a regular building erected for the brokerage business. The rest was leased to a used car dealer. The income from it was less than 2% of the food business gross. The distribution of the land to the sole stockholder in redemption of part of the common stock does not, the IRS rules, qualify as a partial liquidation. It was

neither a contraction of the business nor the distribution of a separate business actively conducted for five years. *Rev. Rul.* 57-333.

No negotiations prior to liquidation; gain on sale taxed to stockholders [*Acquiescence*]. Taxpayer-corporation leased its property in 1929 for 21 years; it gave the lessee the option to purchase the property at any time before January 31, 1951. On May 1, 1950, the corporation learned that the option would be exercised, but prior to any negotiations it liquidated and distributed the property to the stockholders. The lessee exercised the option on January 31, 1951. The court concluded the sale was not to be attributed to the corporation within the rule of *Court Holding Co.,* but was made by the individual stockholders as co-owners. Since the corporation did not make the sale, it could not realize the gain. [Note: Under Section 337 of the 1954 Code, gain is not recognized on sale of corporate assets within 12 months of adoption of a plan of liquidation. *Ed.*] *Merkra Holding Co.,* 27 TC 82, *acq.* IRB 1957-23.

Gain on liquidation of subsidiary by parent comes within provisions of Section 337. A gain of a parent corporation from the liquidation of its subsidiary is a gain from "sale or exchange" of the subsidiary's stock within the meaning of Section 337. This Section permits nonrecognition of the gain should the parent adopt a plan of complete liquidation prior to the exchange, and within 12 months thereafter distribute all of its assets. *Rev. Rul.* 57-243.

OTHER DECISIONS

Stockholders, having bought out minority, have dividend when corporation redeems them. Two 20% shareholders in 1952 purchased all the stock (40%) of a third on the installment basis thereby becoming each 40% shareholders. In 1955, being unable to meet the installment payments, the shareholders had the corporation redeem the purchased shares at the same price they had contracted to pay for them. The redemption is held to constitute a distribution essentially equivalent to a dividend. The IRS adds that even if the redemption were viewed as being made from the former stockholder it would still be a dividend to the remaining stockholders because the effect was an assumption by the corporation of their unpaid notes. *Rev. Rul.* 57-353.

"Royalties" received after transfer of patents are dividends. In 1945 taxpayer transferred harmonica reed patents to a corporation in return for one half of the stock, while another individual invested $25,000 for the other half. The corporation agreed to pay the same royalty to each stockholder on all harmonicas manufactured. In 1951 taxpayer received $18,600 as "royalties" which he reported as capital gain from sale of the patents. The court rules that once the patents were transferred to the corporation as capital contributions, there could be no reason for the corporation to assume an obligation to pay royalties for the use of these assets; the payments are therefore distributions of corporate profits taxable to the stockholders as dividends. Similarly, damages collected after a suit against another corporation for patent infringements, and received by taxpayer after 1945 were dividend income, not capital gain from sale of the patents. *Magnus,* 28 TC No. 100.

Advances were loans by corporation, not dividend. Two stockholders had bought out a third, giving their notes in payment. Thereafter the corporation lent them enough money to pay off their personal indebtedness. The Commissioner treated the advance as a dividend. The court, however, finds that the transaction was a bona fide loan. It was in form a loan, so treated on the books and in the minutes and one of the stockholders paid interest and paid off the note in full. *Perkins,* TCM 1957-128.

Another corporation mortgaging out with FHA funds held collapsible. The court finds no material distinction between the facts here and those in the *Burge* case (28 TC No. 26) (7 JTAX 73) in which it held that Burge realized ordinary income in a redemption of some of his shares in a construction corporation (the funds came from the excess of FHA mortgage funds over cost) and also on the sale of other shares. The only difference here is that the corporation made a distribution but did not redeem any shares. That distinction is irrelevant. Taxpayer had ordinary income on the distribution and subsequent sale of shares. *Glickman,* TCM 1957-124.

Corporation developing unproved oil properties is collapsible. A corporation organized in January 1955 acquired and developed unproved oil properties. At the end of the year the stockholders sold their stock. The selling price reflected the appreciation in value of the properties. The IRS holds the activities of the corporation constituted the construction or production of properties within the meaning of Section 341(b)(1) defining collapsible corporations. Accordingly gain to the stockholders from the sale of their stock is held taxable as ordinary income. *Rev. Rul.* 57-346.

Each bank's net on bond investments computed separately for consolidated return. Banks are permitted to treat a net loss from sales of bonds held for investment as an ordinary loss. The IRS holds that transactions in bonds held for investment by banks which are members of an affiliated group filing a consolidated return are to be computed by each member bank on a separate basis. To the extent such transactions of each member bank result in a net gain, the gains are to be aggregated for computing the consolidated net income. However, if a member bank sustains a net loss from its bond transactions, the loss is to be treated as an ordinary loss in determining the net income of that member. *Rev. Rul.* 57-167.

Computation of years of loss carryback on change in affiliated group. The Regulations provide that any period of less than 12 months for which either a separate or consolidated return is filed because of a change in the affiliated group is considered a taxable year. A corporation becoming a member of an affiliated group during its taxable year and filing a consolidated return for the period following affiliation may carry back to its prior-year separate returns its losses prior to and during affiliation. In computing the two taxable years to which carryback of losses are permitted, the year of affiliation is counted as two—the period prior to affiliation for which a separate return is filed, and the period following affiliation for which a consolidated return is filed. Similarly, when an affiliated group terminates during a taxable year, the periods prior to and following termination are each considered a taxable year. *Rev. Rul.* 57-294.

Decision to sell made during construction; shopping center corporation collapsible. Taxpayer, a plumbing contractor, became a 50% stockholder in a

corporation to build a shopping center. The other 50% stockholder was a large-scale builder. Construction was begun early in August, 1949, the certificate of occupancy was issued December 9 and at least one tenant opened his store in December, though work was still being done and the Tax Court found as a fact that construction was completed about January 1950. The tenant of the largest store, a supermarket, it became apparent, was not financially strong. About December 15, the stockholders authorized a real estate broker to procure a purchaser for their stock, and a contract of sale was signed December 22. The Tax Court found that the decision to sell the stock was made not later than late November or early December. It concludes that the corporation was collapsible and the stockholder's gain is ordinary. The corporation was availed of for the construction of property with a view to the sale of the stock prior to the realization of a substantial part of the net income to be derived from the property. The court upholds the Regulation which says "a corporation is formed or availed of . . . if the requisite view existed at any time during the . . . construction." Construction, the court says, should be interpreted broadly and the project should not be considered constructed until it is in shape to begin to realize net income. *Weil*, 28 TC No. 90.

Land corporation collapsible; gain due to its construction. Taxpayers were stockholders in a corporation which held land to be developed wih FHA financed apartments. The stockholders contracted with two builders (1) to cause the corporation to sell certain land to them; (2) to cause the installation of streets, sewers, etc.; and (3) to arrange FHA mortgage financing. The builder's down payment was paid into escrow and used to make the improvements which had to be made or provided for before the FHA would commit itself. The improvements were begun and the FHA commitments obtained. Taxpayers at this point liquidated the corporation and reported the substantial increase in the value of the land as capital gain. The Tax Court holds that the gain is ordinary because the corporation was collapsible. The activity here was that of the corporation, not its stockholders, and this activity amounted to construction in the broad sense used in the statute. Finally, the corporation was availed of to prevent tax because there is no compelling reason other than taxes for the liquidation. The corporation is therefore collapsible; it was availed of for the construction of property with a view to its distribution to its shareholders prior to the realization of a substantial part of the income. *Abbott*, 28 TC No. 89.

Section 102 tax sustained; corporation failed to meet burden of proof (old law) [*Certiorari denied*]. Taxpayer, a sand and gravel corporation, was found by the Tax Court to be subject to Section 102 penalty surtax for the years 1945 to 1950. It failed to show that its accumulated earnings and reserves of over $6,000,000 were not in excess of the reasonable needs of the business. Taxpayer claimed it needed reserves as a self-insurer, but offered no evidence of the amount. A report on proposed expansion was prepared in 1953 and was obviously based on conditions and plans long after the years in question. The reserves set up on the books for expansion and other contingencies were far less than amounts claimed here as reasonable. It was admitted that the failure to distribute earnings saved the controlling stockholders almost $1,200,000. The Fourth Circuit upheld most of the Tax Court's computations, but remanded the case for further findings on two issues. The Tax Court erred, it said, in holding that no reserve was required to permit it to go into another line if forced by competition. If it reasonably believed it might be forced into another line, it was entitled to the reserve. Further, in computing the need for current working capital, provision should have been made for operating costs as well as overhead. *Smoot Sand & Gravel Corp., cert. den.*, 6/17/57.

Redemption not taxed as dividend though family still in control (1939 Code). Taxpayer owned 1,160, and his son 340, shares, the total stock of a corporation. In 1946-7 taxpayer made gifts of 613 shares to his son and daughter and retained 547. Out of this balance, he surrendered 446 shares, in 1948, in consideration for the cancellation of $22,300 of his indebtedness to the company. The redemption did not affect the business of the company in any way, nor did it impair the capital. Two years later, taxpayer made gifts of his remaining 101 shares to his children and resigned as president and director of the company. The Tax Court held the redemption of the 446 shares "essentially equivalent" to the distribution of a taxable dividend under the 1939 Code. The circuit court reverses. The various transfers were all part of an integrated plan by taxpayer to liquidate his entire stock interest. [The rules of constructive ownership didn't apply under the 1939 Code.—*Ed.*] *Lukens Estate*, CA-3, 3/11/

Officers' salaries reasonable. [*Acquiescence*]. Taxpayer, a structural steel business, was managed by two brothers (with their mother sole owner of the corporation). The Tax Court found salaries paid to them were reasonable; testimony indicated they had greater duties and responsibilities than other executives in the same business. The method of compensation—low fixed salary with high year-end bonus—is found to be common in that industry. *Geiger & Peters, Inc.*, 27 TC No. 113, *acq.*, IRB 1957-23.

"Average funds" employed by finance company exempt from PHC tax. Section 542 excludes from the definition of personal holding company certain installment finance companies, including those making business loans secured by receivables. However, in determining whether a taxpayer has the requisite portion of its income from loans to business secured by receivables there must be excluded loans to a single borrower which for more than 90 days exceed 15% of the "average funds" of the company. The IRS holds that average funds means funds actually invested in receivables, loans secured by receivables and loans secured by tangible personal property. *Rev. Rul.* 57-298.

Redemption through affiliate found disproportionate; not a dividend. Two individuals were 50% stockholders in two corporations and with a third man, were 33⅓% stockholders in another. The third man was inactive in the business and consented to become a full-time employee only if he would have a ⅓ interest in all. To achieve this, the third corporation bought all the stock of the first two from the individuals. Under Section 304 this is a redemption through the use of an affiliate and is treated as a redemption of the stock of the purchasing corporation. The IRS rules that the redemption is substantially disproportionate and, to the extent the price paid does not exceed the fair market value of the stock, the gain is capital. *Rev. Rul.* 57-295.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Must you produce records when Treasury examines those you do business with?

WHAT CAN YOU DO when the IRS demands that you open your records so that it can check another's returns? Such an examination can be quite expensive in terms of executive and clerical time involved, upset in office routine, etc. And, in addition, there can be important problems of customer relations. The public accountant, of course, is in a particularly difficult position. He has been trained to regard his knowledge of his client's affairs as highly confidential, yet he can be forced to disclose them. The ethical businessman has something of the same feeling; he gets even less consideration.

The editors of the *Minnesota Law Review* discuss this entire subject in terms of the rights of third parties in general and with particular reference to banks, accountants, attorneys, hospitals, employers and others frequently called on by the IRS to testify. The complete article, fully annotated, appears in 41 Minn. L. Rev. 800. With permission, we bring you here the highlights.

What information in the possession of third parties can the taxpayer prevent the examiner from obtaining? What information can the third party withhold as a matter of privilege or right; how far must the third party go in producing the requested information?

The "inquisitorial or visitorial" powers of the Treasury Department are extensive, and reach not only the taxpayer and his books and records, but also "any officer or employee of [the taxpayer], or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax . . . or any other person the Secretary or his delegate may deem proper." (IRC Section 7602(2)). In addition to this broad class of persons subject to investigation there is a comprehensive scope of inquiry which extends to *any* relevant or material books, papers, records, data, and testimony of these persons. As under the Internal Revenue Code of 1939, any request for information which the revenue agent may properly make is enforceable through the Federal district court if the request is refused. In addition, the Internal Revenue Code of 1954 gives the examining agents authority previously granted only to the Collector—to issue summonses requiring parties to appear with requested information, and, through a United States District Court, have non-complying parties arrested and punished for either civil or criminal contempt. Thus it is apparent that the inquisitorial power of the Treasury is extremely broad, but this power has long been recognized as a necessary aspect of our revenue laws, and sometimes analogized to the fact-finding powers of Federal grand juries.

This investigative authority is not without confines, however. Within the statute there are limitations as to the scope of inquiry, limitations upon the time and place of the examination, and restrictions against unnecessary examinations and investigations.

Scope of inquiry

The examination must bear upon matters required to be included in the return under investigation. If the agent identifies the document with sufficient particularity and shows that it is relevant to his examination, then his examination will not be condemned under the traditional cry that it is a "fishing expedition." It is merely the arbitrary inquiry that is prohibited. However, an examining agent cannot conduct an examination of a taxpayer or his records to obtain the names of unknown and unidentified parties who may have failed to report income. Thus, a corporation could not be compelled to produce its records which would reveal the identity of persons to whom payments had been made, where the tax liability of the corporation was not under investigation, nor could a trustee be compelled to disclose the names and addresses of the beneficiaries of certain trusts who were identified only by the type of information sought. However, a corporation which sought to withhold its records to prevent disclosure of the names of stockholders involved in an exchange of stock between corporations was required to produce its records. Although these latter two cases appear to reach opposite results, they are reconcilable in that the request in the former case only vaguely identified the taxpayers under investigation by the nature of the information sought. This information in itself could be obtained only by a laborious analysis of many wills; in the latter case the class of persons was clearly identified and the information sought imposed no undue burden upon the corporation to inspect voluminous records. These cases demonstrate that the agent does not have to specifically identify taxpayers under investigation, but must identify them with a reasonable degree of particularity. The agent must indicate that he is investigating a reasonably definite individual or group and is not just performing the examination to see what he may uncover.

Time and place of examination

A corporate president has been required to bring corporate records to the revenue agent's office twenty-five miles away and leave them there for an anticipated investigation of four months' duration. However, the examination in that case had previously been attempted in the taxpayer's office, and after a great deal of interference by the corporate employees, the agent resorted to the subpoena power to get the desired information. Presumably the same rule applicable to taxpayers under investigation applies to third parties since Section 7605(a) merely refers to examinations pursuant to Section 7602, which does not distinguish between taxpayers and third parties.

Unnecessary investigations

The right to be protected against unnecessary examinations or investigations is personal to the taxpayer under investigation, and a third party cannot refuse to produce the requested documents

on this basis. Similarly, a taxpayer whose records have been examined with respect to his own liability cannot refuse to give information from his records which is later sought with respect to another taxpayer.

Examinations barred by statute

A restriction not set forth in the statute but implicit in the Treasury's investigative power is the rule that no examination may be made concerning tax liability for years which are barred by the statute of limitations. Consequently, in order for the revenue agent to obtain information from either the taxpayer's or a third party's records after the statute of limitations has run, it is necessary that the agent allege fraud on the part of taxpayer whose tax liability is in question. This does not greatly burden the agent, however, since he is not obliged to disclose in detail the facts relative to the investigation; nor is the district court obliged to require facts showing reasonable grounds to believe that the returns were false or fraudulent where the agent testifies that his investigation up to that point has raised a strong suspicion that the taxpayer filed a false or fraudulent return for years barred by the statute of limitations. In the case of a suspected omission of more than 25% of gross income, it appears that the test as to whether an examination can be made after the expiration of the normal three-year statute of limitations will be similar to the test in the case of suspected fraud.

In *United Distillers Products Corp.* (156 F.2d 872 (2d Cir. 1946)) the court allowed the examination after the running of the three-year statute, stating: "Obviously, this provision [extending assessment time in the case of an omission of more than 25% of gross income] would be of no practical effect if the Bureau were barred from making the investigation necessary to ascertain such a misstatement. Nor should it be required to prove the grounds of its belief prior to examination of the only records which provide the ultimate proof."

Constitutional limitations

Both the Fourth Amendment, prohibiting unreasonable searches and seizures, and the Fifth Amendment, establishing the right against self-incrimination, are applicable to the inquisitorial powers of the government. However, the application of these amendments in the case of third persons from whom information is sought in tax investigations is different both in scope and degree from their normal application.

The United States Supreme Court in recent times has tended to revert to a more literal interpretation of searches and seizures and subordinate privacy to the public interest. The new attitude of the Supreme Court toward administrative investigations is readily apparent in one of its recent decisions: nothing more than official curiosity may justify the inquiry. But the court qualifies its position saying, Of course a Governmental investigation into corporate matters may be of such a sweeping nature and so unrelated to the matter properly under inquiry as to exceed the investigatory power. . . . But it is sufficient if the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant.

It should be noted that the taxpayer under investigation may not prohibit the production of a third party's records on the ground that it is an unreasonable search, since that is a privilege personal to the *owner* of the records.

The Fifth Amendment privilege against self-incrimination also has a limited application to the inquisitorial powers of the Treasury as applied to third parties. A third party may not refuse to produce his records for examination in the determination of another's tax liability unless in so doing he would incriminate himself. An officer of a corporation may be required to produce corporate records even though such evidence may incriminate the officer or the corporation.

In contrast to this impersonal treatment of corporate records for purposes of the Fifth Amendment, is the treatment of partnership books. Partnership books are considered to be of a personal character and a partner can properly refuse to produce them on the grounds that they may tend to incriminate him. Whether this rule will be given unlimited application regardless of the size of the partnership is questionable when viewed in the light of the Supreme Court's decision in *White*. (322 U.S. 694 (1944)). There the court held that an officer of an unincorporated labor union had no right under the Fourth and Fifth Amendments to refuse to produce union records in his possession on the ground that they might tend to incriminate either the union or himself. In so holding the court stated: "The test . . . is whether one can fairly say under all the circumstances that a particular type of organization has a character so impersonal in the scope of its membership and activities that it cannot be said to embody or represent the purely private or personal interests of its constituents, but rather to embody their common or group interests only."

It appears that the Fifth Amendment could be further limited in its applicability to administrative investigations by the so-called quasi-public records exception. In *Shapiro* (335 U.S. 1 (1948)) the Supreme Court held that records required to be kept by the Emergency Price Control Act became public and therefore could not be withheld from examination on the ground of self-incrimination. It has not been decided whether records required to be kept pursuant to the Internal Revenue Code and the applicable Regulations, are within this exception, but as one of the dissenters in the *Shapiro* case pointed out, there is no reason for not applying it to any law requiring records to be kept, including Section 54(a) of the Internal Revenue Code of 1939. The public records doctrine, if followed in the tax field, would increase immensely the scope of the Treasury's investigative powers, especially in fraud investigations where the Fifth Amendment most often comes into play.

Accountants

The accountant appears to be the most vulnerable of the third parties. Whether or not he is certified, the accountant like any other third person, cannot refuse to turn over the taxpayer's books and records if he has them in his possession when he is served with a valid subpoena, and a refusal to comply with such a subpoena may result in liability for criminal contempt. It is also well established that the accountant, like any other third party, cannot claim the privilege against self-incrimination for the taxpayer. Only if he claims it for himself can the accountant assert the Fifth Amendment privilege, which even then will extend only to such papers and documents as belong to the accountant or are in his possession in a purely personal capacity.

Furthermore, the accountant does not have a privileged relationship with his client similar to the attorney-client privilege. In *Falsone* (205 F.2d 734 (5th Cir.); *cert. den.*, 346 U.S. 864 (1953)),

the court quoted Wigmore in giving its reason for the denial of the privilege, saying: "The investigation of truth and the enforcement of testimonial duty demand the restriction, not the expansion, of these privileges. They should be recognized only with the narrowest limits required by principle. Every step beyond these limits helps to provide, without any real necessity, an obstacle to the administration of justice."

Even though the rules and regulations of the Treasury Department grant to an enrolled agent the same rights, powers, and privileges . . . as an enrolled attorney, this does not include the right to assert a privileged accountant-client relationship. Federal courts also disregard state law providing that communications between the accountant and his client shall be privileged, saying that such statutes are inapplicable to administrative proceedings between the taxpayer and the Federal government. Nor will the fact that the accountant is hired by an attorney make the accountant's communications with the client or his records privileged. The two cases establishing this proposition are *Himmelfarb* (175 F. 2d 924, 939 (9th Cir. 1949), *cert. den.*, 338 U.S. 860 (1949)), and *Gariepy* (189 F. 2d 459 (6th Cir. 1951)). In *Himmelfarb* a lawyer had engaged an accountant in connection with a tax fraud case against one of the lawyer's clients. The accountant had participated in several conferences with the attorney when the client was present. Later at the trial when the accountant was called as a Government witness, objection was made to the admission of his testimony because of the attorney-client relationship. However, the court held there was no privilege and analyzed the law as follows: (1) If the taxpayer disclosed the information to the accountant there was no privilege. (2) If the disclosures were made by the taxpayer to the attorney in the presence of the accountant, the taxpayer impliedly authorized the attorney to make disclosures and thereby waived the privilege. (3) If the attorney made disclosures to the accountant without the taxpayer's consent the privilege would attach.

The court in applying the second rationale reasoned that since the accountant's presence was not indispensable in order for the communication to be made to the attorney, no privilege attached. In the *Gariepy* case an accountant was forced to testify in a tax fraud case as to the source of certain income to the taxpayer. Although the accountant was not hired by the attorney, the court reiterated the proposition that the privilege would not apply even if he had been so employed.

A rationale that has been successfully used to prevent pre-trial discovery of information relating to litigation between two *private* parties, is the work product doctrine. Under this doctrine the attorney-client privilege has been held to apply to the employment of various experts by the attorney. Since the accountant is an expert in the preparation and analysis of financial records it seems logical that the attorney-client privilege should apply when he is employed by the attorney and the work performed is turned over to the attorney. It was so held in *Colonial Airlines, Inc.*, where suit was brought by the corporation against corporate officers for the improper expenditure of funds. A firm of public accountants had compiled an audit of the corporation's books. In holding that the report need not be produced for copying, the court found that it was prepared at the request of the corporation's counsel in preparation for defense of another suit and in prosecuting the suit in question, and that the regular books were available. The court reasoned that since the work was done in preparation for trial, the work product doctrine applied, and the report need not be produced. Whether this doctrine will be readily accepted by the courts when the problem involved is the collection of taxes rather than litigation between private parties is questionable. However, it appears to rest on firmer ground than the rationale of the *Himmelfarb* case.

Accountant-attorneys

As to the person who is both an accountant and a lawyer, the type of service performed for the client will determine the availability of the privilege. In *Olender* (210 F. 2d 795, 806 (9th Cir. 1954)), the taxpayer employed a member of an accounting firm who was both a certified public accountant and an attorney to prepare a net worth statement and income tax returns for him. When the accountant-lawyer later claimed his communications with the client were privileged, the court held him to be engaged strictly in accounting work and denied him the privilege. In an earlier case it was held that an accountant who later became the firm's lawyer could not claim his communications at the time he was an accountant to be privileged although he later rendered legal advice based upon that data.

Although the accountant's books and papers are actually transferred to an attorney, such records are not privileged. As stated in American Jurisprudence, "The reason is obvious; the administration of justice could easily be defeated if a party and his counsel could, by transferring from the one to the other important papers required as evidence in a case, thereby prevent the court from compelling the production of important papers on a trial."

Nor is the accountant in a position to raise the objection that the examination or investigation is unnecessary, since this objection is available to the taxpayer alone. Thus it appears that the accountant is practically defenseless when served with a valid subpoena. In only two situations will privilege apply. First, where information is communicated to the accountant by the attorney in the absence of the client and without the client's consent. Second, where the accountant is both an attorney and an accountant, and has obtained the information while performing *legal* services for his client.

Attorneys

The attorney is in a much better position to withhold information than any other third party, his best defense being the attorney-client privilege. However, the attorney cannot refuse to be sworn, but must assert the confidential privilege as the occasion arises. The privilege is not absolute, but extends only to documents and information received by the attorney while engaged in his professional capacity. For instance, where the lawyer had performed clerical and bookkeeping services in the handling of a commercial bank account for his client, no confidential privilege attached. Nor does the privilege attach where the lawyer simply deposits funds in a bank for his client, or acts as a mere scrivener on transactions involving the transfer of title to real estate. Similarly, privileged communications cannot be made to the attorney in furtherance of a crime—such as tax evasion—since such advice would not be rendering a professional service but rather would be participation in a conspiracy.

Anything the taxpayer himself can assert as being privileged can be withheld by the attorney if the information

or books and records are in the attorney's possession. However, the attorney-client privilege does not attach to documents solely because they are transferred to an attorney's possession, whether the transfer is made by the taxpayer or some third party. If the question of privilege is in dispute undoubtedly the attorney will want to, or have to, turn over the documents to the district judge for a determination of whether the privilege is applicable. The decision of the court in this respect is usually held to be appealable.

Both the privilege and the right to waive the privilege are personal to the client. However, the attorney should keep in mind that the client will be deemed to have impliedly waived the privilege if a third person, not the attorney's clerk or secretary, is present when the communications between the client and attorney take place.

Closely allied to the attorney-client privilege is the need for privacy and freedom from interference in preparation of the client's case for trial. This concept, embodied in the work product doctrine, is designed to protect the effectiveness of the lawyer's preparation for trial and is incorporated into the Federal Rules of Civil Procedure encompassing pre-trial discovery. We are dealing here with disclosures in an administrative proceeding and the applicability of the Rules is somewhat questionable; moreover, at this stage of the examination little, if any, work will have been done in preparation for trial.

Banks

Banks constitute one of the major groups upon which the Treasury makes demands for information and records. They too cannot assert the privilege against self-incrimination on behalf of the taxpayer, since this is a personal defense of the taxpayer. The unreasonable search and seizure prohibition of the Fourth Amendment has been held to be inapplicable. However, courts in fact do impose limitations on breath relevancy of subpoenaed information on the ground that the inquiry is oppressive or unreasonable.

In *United States ex rel. Sathre v. Third Northwestern Nat. Bank,* (102 F. Supp. 879 (D. Minn. 1952), *dismissed on stipulation of parties,* 196 F.2d 501 (8th Cir. 1952)) a Special Agent of the Intelligence Unit wanted: "all records of cashier's checks, bank money orders and certificates of deposit purchased by, endorsed by, or paid to or for [twelve or thirteen individuals] together with any and all such paid, cashed, or honored cashier's checks, bank money orders and certificates of deposit and supporting documents and records." Although the agent attached a note offering to check the records himself if the bank desired, the bank refused the offer and failed to obey the summons. The court held that the bank need not examine voluminous records for the purpose of finding cashier's checks, etc., of a suspected evader, where there was no showing of reasonable grounds for belief that such items even existed.

Pertinent records

Likewise, a bank cannot be compelled to unfold voluminous records containing information concerning people whose tax liability is not under examination. In *First Nat. Bank of Mobile* (160 F.2d 532 (5th Cir. 1947)), the court said: [The agent] "may first obtain information as to what papers or documents are within the Bank's possession relevant to the inquiry by interrogating, under oath, an appropriate officer of the Bank. Upon a satisfactory showing by the agent that certain pertinent records or documents have a bearing upon matters required to be included in the return under investigation, the Bank would be required to produce them for the inspection of the agent, whereupon the agent would determine for himself whether or not they were relevant to his needs and take copies thereof if he so desired." In so stating, the court modified the original order to produce, by confining it to records relevant to the taxpayer under investigation rather than allowing the original order which requested records irrespective of whether such records also pertained to similar transactions [between the bank and] other persons or firms.

As early as 1928 it was held that the depositor had no proprietary interest in a bank's books or records and, at most, could claim that such records should not be disclosed for the purpose of inflicting deliberate injury upon him. In that case the agent asked for records of deposits and withdrawals of a certain taxpayer for a period of two years. The court in upholding the agent reasoned that a proceeding to obtain the information invaded no rights of the depositor under the Fourth Amendment as to unreasonable searches and seizures. Nor could the bank refuse production of the records on the basis that some of the entries would relate to transactions of persons whose tax was not under investigation.

In summary, banks must generally obey the subpoena, but can refuse if they show: (a) that the request is unreasonably broad in scope; (b) that the records sought are not readily identifiable and conveniently obtainable; (c) that they are not relevant to the inquiry; (d) that previous investigations of the same records have rendered further investigations unnecessary or oppressive; (e) or that the revenue agent has acted arbitrarily, capriciously, or with any motive other than to make a lawful examination.

One area of uncertainty relative to banks as third parties is the application of the inquisitorial powers to information contained in safe deposit boxes. However, since the normal contract between the bank and a safe deposit box renter places the renter in control, it would seem that a demand to produce the contents of a safe deposit box would have to be made upon the renter rather than the bank.

Employers

Most employers have a wealth of information concerning their officers and employees and therefore are frequently the subject of an internal revenue agent's inquiry. In *Local 174, International Brotherhood of Teamsters, AFL-CIO,* (240 F.2d 387 (9th Cir. 1956)), the Internal Revenue Service suspected fraud in the tax return of one of the union's employee-officers and was inspecting union records to verify its beliefs. However, the Court of Appeals held the district court's order to produce any and all cash books, day books, bank deposit slips, cancelled checks, check stubs, loan ledger cards, individual payroll records, financial statements, and tax returns for a ten-year period to be arbitrary and unreasonable. In denying the order the court said there was no showing that any specific item or document was relevant to the investigation, material to the inquiry, or that the documents were in the possession of the union. A vigorous dissent rejected the majority's position except as to the unlimited time factor. Categorizing the majority as students of the old school of thought on the scope of administrative investigations, the dissent emphatically pointed to the more recent liberal treatment of such investigations. He sug-

gested that the holding severely curtailed the administrative power of investigation and completely ignored the public interest. Since the order for the production of the records did not confine itself to records pertinent only to the official under investigation, the holding appears consistent with the recent cases. However, since the Internal Revenue Service sought to prove that the official had never repaid loans made to him, it is doubtful whether the order could have been drafted in any other form and still have obtained the necessary information. In this respect the dissent seems to see the realities of the situation and would appear to reach the more practical result.

In *Boren v. Tucker,* (239 F.2d 767 (9th Cir. 1956)) the request to the employer-corporation was to produce for examination, copying photostating or photographing, the general journal, cash journal, general ledger, and payroll records and checks bearing certain signatures, all for a six-month period. The examination was being conducted in connection with the income tax liability of the corporation's president and vice-president, who were husband and wife. In upholding the civil contempt of the two officers and the corporation itself, the court held that the examination was not a re-examination but a continuation of a previous examination; that an examination included the right to photostat the records; that the examination was not precluded by the possibility that a criminal prosecution might arise from it; and that the facts showed that the records were reasonably relevant and material. One of the major reasons the order was found proper was the relatively short period covered by the requested records.

It appears that the employer, as well as other third parties, will be better advised to base his refusal to produce the demanded information upon the ground that the scope of the examination was unduly broad, rather than upon the possible tax or criminal consequences that might arise from furnishing the records specified by the IRS.

Business associates

Those who engage in business transactions with the taxpayer may also be compelled to produce their records when information regarding the taxpayer is sought. This is so even though the books and records of the associate may have been examined with respect to his own tax liability on a previous occasion.

Hospital records

Hospital records are another source of information which the Internal Revenue Service may obtain upon a proper request. In the case of *In re Albert Lindley Lee Memorial Hospital,* (209 F.2d 122 (2d Cir. 1953)) the agent was seeking information relative to a doctor's income tax liability. The court allowed examination of the hospital records to obtain the names and addresses of patients, although the court said the nature of the patients' illness should not be disclosed to the agent. The court went on to say that as to any subsequent interrogation of the patients, "The public interest in the collection of taxes owing by a taxpayer outweighs the private interest of the patient to avoid embarrassment resulting from being required to give the revenue agent information as to fees paid the attending physician." In *Gretsky v. Basso,* (136 F. Supp. 640 (D. Mass. 1955)) a hospital treasurer was also required to produce the records desired by an agent, although the agent was specifically instructed not to copy the nature of any illnesses from the record. The rationale of the courts in the hospital cases is that since the doctor-patient privilege does not prohibit the disclosure of the names of the doctor's patients, the hospital should also be required to disclose the names of its patients. ☆

New fraud and negligence decisions

Taxpayer's opening net worth accepted. The Commissioner reconstructed taxpayer's income from his increase in net worth plus expenditures. The only question in issue was the amount of opening net worth. Upon the facts, the court accepts taxpayer's testimony that he had purchased certain heavy equipment before the years at issue here so that they were to be included as assets in opening net worth. *Peterson,* TCM 1957-96.

Summary judgment refunding penalties improper; issue of willfulness was controverted. The district court granted summary judgment to taxpayer suing for refund of penalties for failure to pay over withholding tax. He was president of a company accused of willful failure to collect, account for and remit withholding taxes of employees. Penalties had also been paid by taxpayer personally. The circuit court orders a trial on the controversial issue of willfulness. *Gardner,* CA-9, 5/23/57.

"Routine" examination of lawyer in search for IRS wrongdoing is trickery barring evidence of his evasion. The IRS suspected some of its own personnel of wrongdoing and a special team of agents from other areas began an investigation. Taxpayer here, a lawyer, was thought to be involved. Accordingly, examination of his affairs was begun and it was represented to him as routine. While no evidence of improper dealings with IRS personnel was uncovered, tax evasion was discovered, and taxpayer was indicted. He moved for suppression of the evidence the agents obtained on the ground it was obtained by misrepresentation and the examination was an unlawful search under the Fourth Amendment. The judge orders the evidence suppressed. The search for criminal evidence under the guise of a routine examination was trickery. To secure evidence without making disclosure when crime is suspected is a fraud and violation of constitutional rights. Taxpayer's action in permitting the agents to keep the records after his true position was revealed was not a ratification. To demand return of the books after the agent had examined them would be a nullity. *Wheeler,* DC Pa., 3/20/57.

Government can use husband's records given it by estranged wife. Taxpayer's wife, without his knowledge or consent, and while their divorce was pending, turned over her husband's business records to the Service. Taxpayer was indicted for failure to file income tax returns, but the district court ordered the records so obtained be suppressed. This court reverses that order. The Government merely accepted papers turned over to it. It made no wrongful search or seizure. *Ashby,* CA-5, 6/14/57.

Used car dealer's gambling winning determined. Taxpayer was a used car dealer. Net worth computations for 1946-1948 showed a $700 discrepancy for 1947 which the court sustains. For 1949 and 1950, however, the Commissioner recomputed income by adding back cer-

tain checks issued by another businessman with whom taxpayer frequently gambled for high stakes and from whom taxpayer usually won. However, the court reduced the addition for 1949 from $13,000 to $2,000 and for 1950 from $46,000 to $24,000. Fraud penalties for these two years are upheld. *Corum,* TCM 1957-111.

Criminal prosecution for non-payment valid despite filing of return. Taxpayer had filed returns for 1954 and 1955, but didn't pay the tax. He was indicted for wilfully failing to pay. He asked that the court dismiss the proceding on the ground that enforcement of the law against him was discriminatory. It was shown that in this particular district there had never been another criminal prosecution against a taxpayer who had filed a timely return but not paid the tax and that there are currently pending in all district courts in the country only two such cases. The court observes that failure to enforce the law against all criminals is no defense to one prosecuted and refuses to dismiss. *Palermo,* DC Pa., 5/31/57.

Builder's total understatement of income was $100,000 in four years. The Commissioner asserted deficiencies based on net worth computations for 1948-1951. Taxpayer asserted that his records for his construction business were adequate and correct but the court holds he did not meet his burden of proving they were since the Commissioner determined they were not. In the net worth computation itself the taxpayer did not show it was unreasonable, nor that leads were ignored, nor was there error in computation. Penalties for failure to file estimates and one return, and for substantial underestimate are also assessed. *Harp,* TCM 1957-105.

Fraud in ship chandler's overstatement of commissions to ships officers. Taxpayer sold supplies to ocean-going ships and claimed commissions paid to the ships officers. The court finds that all ship chandlers pay such commissions and that they are an ordinary and necessary expense. However, the amounts claimed by taxpayer varied from 9% to 17% of sales and the court finds that this is a fraudulent overstatement, the customary commission being 5%. The court notes that it is possible to make errors in estimates but the large difference here, plus taxpayer's business ability, shows the cause to be fraud. *Valetti,* 28 TC No. 75

Fraud conviction by net worth method sustained. Taxpayer operated a pawnshop. Once a month a bookkeeper wrote up the books from memoranda supplied by the taxpayer. Most of the income and expenses of the business were in cash and revenue agents were unable to verify them. The Government computed taxpayer's income by the net worth method. Defendant's nonbusiness expenditures over the four-year period involved in the indictment exceeded reported income by $280,000, which taxpayer explained by saying he had a large cash hoard, accumulated in prior years. Conviction for willful evasion is affirmed. *Epstein,* CA-6, 7/2/57.

Jury finds doctor fraudulently understated income. Few facts are reported. Taxpayer paid deficiencies, interest and fraud penalties and then sued for refund. The jury finds underpayment and fraud. *Harris,* DC Ga., 6/19/57.

Can't suppress evidence under Fifth Amendment prior to indictment. Taxpayer alleged that the district attorney was about to ask for his indictment and he sought a court order to suppress evidence—his books and records, delivered to Special Agents after, he claimed, the collector had assured him he did not consider the case appropriate for prosecution and that taxpayer would be safe in turning over the records. The court reviews cases in other circuits which have suppressed evidence in the pre-indictment stage when violation of the Fifth Amendment (self-incrimination) was involved. Rules of Criminal Procedure allow suppression when the Fourth Amendment (unreasonable search) is involved. The court concludes that if pre-indictment suppression should be allowed for the Fifth Amendment, it should come about by amendment of the rules—not decisions. However, lest it be in error on this point, the court considers the case on its merits. The district court found as a fact that there was no misrepresentation or trickery and that the books were handed over voluntarily. It cannot say that finding was erroneous. *Biggs,* CA-6, 7/5/57.

Income tax evasion is a felony, not misdemeanor. Following *Achilli,* decided May 27, 1957 by the Supreme Court, the court holds there was no error in indicting taxpayer for income tax evasion under the felony statute. *McDonald,* CA-10, 6/20/57.

Net worth used to determine oculist's income. The Tax Court held that the net worth method was justified in determining the taxable income of an oculist and eye surgeon whose professional receipts as recorded in a receipt book failed to reconcile with the actual deposits, and who produced no records from which the total amount received from operations could be determined. The Tax Court upheld the fraud penalty, concluding that taxpayer in preparing and filing his return was aware that they were not true. The circuit court affirms. Consistent failure to report substantial amounts of income over a period of years, standing alone, is effective evidence of fraudulent intent. With regard to the use of the net worth method, the circuit court holds that the fact that the books on their face appear adequate does not preclude the use of the net worth method. The net worth method may be used to test the correctness of the books and also as evidence of the amount of unreported income. *Schwarzkopf,* CA-3, 7/10/57.

Income of gamblers reconstructed from commissions paid out. The Tax Court sustained the Commissioner's determination of the gross profit of a betting syndicate by multiplying the commissions paid to "runners" by four, since it was shown that they were given bonuses totalling 25% of the retained gambling profits. This court affirms. *Nowland,* CA-4, 5/15/57.

Fraud penalty assessed against gambler. A gambler prepared his tax returns by the "expenditures" method, reporting as income his total personal expenditures for the year. The available records, although incomplete, showed considerably more gross receipts from gambling operations than that reported. The Commissioner is sustained in his imposition of the fraud penalty. *Sullivan,* TCM 1957-131.

Use of formulas to reconstruct gambling income upheld. Taxpayers were partners in a casino which provided gambling facilities on an extensive scale. Because of lack of adequate records, the Commissioner reconstructed the partnership income by using the following formulas based on nationwide exper-

ience: 12% of gross amount bet for computing winnings on the "horse-book"; 79% of gross amount played for computing winnings from the slot machines; and ten times salaries paid for computing winnings from the dice games. The court sustains the determination as reasonable in the absence of any evidence on taxpayer's part showing the determination to be erroneous. One dissent. He would say the taxpayers had shown the Commissioner's formulas were arbitrary. This shifted the burden back to the Commissioner and he did not then show his estimates were reasonable. *Delsanter,* 28 TC No. 94.

Diversion of corporate funds fraudulent. Taxpayer Clark was president and controlling stockholder of a corporation engaged in the wholesale plumbing business. Koyl was vice president and owner of the rest of the stock. Substantial amounts of corporate income were unrecorded and unreported for tax purposes. The court finds that taxpayer was the chief perpetrator of various schemes to siphon off corporate earnings and admittedly withheld large sums. It upholds the Commissioner's treatment of such diversions as informal dividends to taxpayer in an approximate relationship to his stockholdings. Taxpayer's failure to include the sums in his return is held to be false and fraudulent with intent to evade taxes. *Clark,* TCM 1957-129; *Koyl* TCM 1957-130.

Grunewald conspiracy outlawed; can't be extended to concealment. The Supreme Court finds that prosecution in the famous tax-fixing case was barred by the statute of limitations. The Government had argued that acts of concealment of the conspiracy, which had occurred within three years of indictment, were themselves acts of conspiracy. The Supreme Court refuses to permit such a widening of the scope of conspiracy; it would indefinitely extend the statute of limitations in practically every criminal case. *Grunewald,* Sp. Ct., 5/27/57.

Fraud in politician's failure to report fees as tax consultant. In 1939 to 1943, the years in issue, taxpayer was director of purchases and industrial engineer for the City of Newark and treasurer of a Democratic club. The Commissioner produced evidence of payment to him of about $40,000 dollars paid by three affiliated companies on invoices he submitted as tax consultant for services in connection with Jersey City taxes. The Commissioner also offered net worth computations to show that taxpayer retained the funds though he argued that he paid part to lawyers associated in the work and the balance was a political contribution. The court finds that taxpayer received and kept the funds, and that the omission of them from his returns was due to fraud. *Ridenour,* TCM 1957-126.

Confused records didn't support tax returns; negligence penalty sustained. The revenue agent examining taxpayer's returns testified that the records were in such a confused state it was impossible to determine how the amounts of income reported had been determined and that numerous corrections and adjustments had to be made. The court sustains negligence penalties for all the years in issue. *Perkins,* TCM 1957-128.

Understatement and fraud proved though return had been destroyed. Despite its decision in this case at TCM 1956-251, the court permitted a new argument—that the finding of fraud in 1942 must be reversed because the Commissioner had, as permitted by law, destroyed taxpayer's 1942 return. The court holds that the IRS index records notation that the 1942 return showed no tax, together with the accountant's copy showing a loss, is proof that taxpayer reported no income. The court refuses to disturb its decision. *Samkoff,* TCM 1957-123.

Stockholder diverted funds to personal account; fraud sustained. The court finds fraud in the returns filed by both a corporation and its stockholders. The corporation operated taxicabs, busses, limousines, etc. Its records were kept by a full-time bookkeeper whose work was supervised (though not audited) by a CPA firm which prepared the tax returns. In 1946 one of the employees of the accounting firm became suspicious that all of the receipts of the business were not deposited in the regular bank accounts, but were going into an account of the wife of the sole stockholder. By 1948 he was sure of it and showed that some $10,000 was so diverted in that year. Correction of the books was made and the return filed included that income. The Commissioner examined the returns back to 1942 and asserted deficiencies and fraud penalties. The corporation argued that the stockholder-executive was ignorant of accounting matters and relied on the accountants to include its income from all sources. The court finds, however, that the concealment was deliberate and that the accountants were purposely misinformed. The court sustains the deficiencies and fraud penalties. The withdrawals, it also holds, should be treated as dividends on the personal returns, to the extent of available earnings and profits. *Bender,* TCM 1957-121.

Court accepts books, not net worth estimates. The Commissioner made net worth computation for the years 1946 through 1950 and asserted large deficiencies and fraud penalties. Absent fraud, all the years but 1950 would be closed. Taxpayer operated a moving picture theatre for which detailed and apparently complete books were kept by employees. The Commissioner showed no other source of income. The court noted substantial errors in the net worth computations. It concludes that taxpayer's books are more reliable evidence that the net worth estimates and that no fraud was shown. For 1950 it sustains a deficiency but no fraud penalties. *Lea,* TCM 1957-119.

No deficiencies in years unreported income was offset by kickbacks. For four of the six years in issue the court found that though taxpayer's income was understated it should be allowed deductions tfor kickbacks paid to ships officers on sales of goods they purchased for the ships. In two other years, however, the unreported income was greatly in excess of the unrecorded kickbacks. Finding that taxpayers must have been aware of the substantial understatement, the court sustains both the deficiencies and the fraud penalties. *Richardson,* TCM 1957-122.

Fraud penalties imposed on garment contractors. Taxpayers conducted a garment contracting business as partners. They performed all their services for two manufacturers during 1944-1945. A comparison of the purchases recorded on the books of the manufacturers with the sales account on the partnership books revealed consistent understatements of income. Taxpayers also failed to report any income from their stock brokerage accounts and made no appearance at the trial. The court sustains the Commissioner's imposition of fraud penalties. *Seif,* TCM 1957-136.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Supreme Court rules Tax Court does not have inherent judicial power

THE STATUS OF the Tax Court has been in question lately and practitioners awaited the Supreme Court decision in the *Lasky* case with interest. While the point at issue, whether or not the Tax Court has the inherent judicial power to vacate a decision, seems quite technical, the powers of the Tax Court take on importance in the light of current proposals to transfer its function to a new court to give judicial review to administrative agencies. There has been a flare-up of interest recently in the perennial question of whether or not appeals from the Tax Court should fan out to the nine circuits, with all the problems that brings of consistency and uniformity.

Before the *Lasky* decision came down, Harry J. Rudick, writing in the New York University Law Review Annual Survey of American Law, correctly forecast an affirmation. The Supreme Court did it the way he saw it — it affirmed, citing merely the *Northern Coal* and *Simpson* cases, which held that the BTA had no power to grant a rehearing after its decision became final. The Supreme Court thus avoided the issue of whether or not the Tax Court is a court. The following excerpt gives Mr. Rudick's analysis of the problem in advance of the Supreme Court decision since handed down.

"By statute the Tax Court is 'an independent agency in the Executive Branch of the Government.'[1] It has jurisdiction only as conferred upon it by the Internal Revenue Code.[2] The Code provides that a decision of the Tax Court becomes 'final' within three months after a decision is rendered unless within that time an appeal is filed to the United States Court of Appeals.[3]

"Courts have the inherent power to vacate their decisions and this power is confirmed in rule 60(b) of the Federal Rules of Civil Procedure. The Federal Rules, however, do not apply to the Tax Court because of its status as an executive agency.[4] Is the Tax Court, nevertheless, a court with inherent power to vacate its decisions? In *Lasky*,[5] the Ninth Circuit decided that the Tax Court does not have such power, but the Sixth Circuit, in *Reo Motors*,[6] had decided that it does.

"The facts in the *Lasky* case are that on April 8, 1954, a decision was entered against the taxpayer by the Tax Court. Due to excusable neglect through misfiling of the decision in the office of taxpayer's former attorney, the three-month period for filing an appeal was allowed to run. Four months after the entry of decision, taxpayer filed a motion in the Tax Court to vacate the earlier decision and for the taking of additional evidence. The motion was granted and after reconsideration the Tax Court rendered a second adverse decision. From this decision the taxpayer appealed. The circuit court dismissed on the ground that it had no jurisdiction to review the second decision because the Tax Court had no power to set aside its first decision which had become final.

"It seems likely that the Supreme Court will affirm the *Laskey* case. Aside from the Sixth Circuit in the *Reo Motors* case, the four other circuit courts which have considered the question have all concluded that the Tax Court had no inherent judicial power to review its decisions and that its decisions become 'final' within ninety days if not appealed.[7] The Ninth Circuit had previously decided this same issue in *Swall*.[8] Moreover, the Supreme Court has in decisions involving its own power to grant rehearing of its own judgments affirming decisions of the Board of Tax Appeals, which under the Internal Revenue Code became 'final' 30 days after which issuance of the mandate by the Supreme Court,[9] held that it had no power to grant a rehearing after the expiration of the 30 days.[10] It would thus seem that even if the Supreme Court were to hold that the Tax Court had inherent judicial powers, it would not necessarily permit the Tax Court to vacate its judgment after the expiration of the 90-day period provided by the Code for the decision to become 'final.'" ☆

When the Supreme Court decided the *Lasky* case it affirmed the circuit court, merely citing the *Northern Coal* and *Simpson* cases Mr. Rudick discussed.

[1] Int. Rev. Code of 1954, ¶7441.
[2] Int. Rev. Code of 1954, ¶7442.
[3] Int. Rev. Code of 1954, ¶¶7481(1), 7483.
[4] Katz v. Commissioner, 188 F.2d 957 (2d Cir. 1951).
[5] 235 F.2d 97 (9th Cir.), cert., 352 U. S. 889 (1956).
[6] 219 F.2d 610 (6th Cir. 1955).
[7] White's Will v. Commissioner, 142 F.2d 746 (3d Cir. 1944); Monjar v. Commissioner, 140 F.2d 263 (2d Cir. 1944); Sweet v. Commissioner, 120 F.2d 77 (1st Cir. 1941).
[8] 122 F.2d 324 (9th Cir.), cert. den., 312 U. S. 697 (1941).
[9] Revenue Act of 1926, ¶1005(a), 44 Stat. 110.
[10] Helvering v. Northern Coal Co., 293 U. S. 191 (1934). Cf. R. Simpson & Co. v. Commissioner, 321 U. S. 225 (1944).

Tax litigation increases; backlog of cases lessens

THE TAX DIVISION of the Department of Justice made continued progress in reducing its backlog of pending cases during the first six months of 1957, despite a heavy increase in the volume of incoming work, both civil and criminal, according to Assistant Attorney General Charles K. Rice. The workload was reduced by more than 800 cases and that the cut during the past three years has exceeded 2,000 cases. During that time, he said, the new business of the Division has increased by about 30 per cent.

Pointing out that the Tax Division has had an increase in new business in every year except one since 1947, Mr. Rice said:

"It seems conservative to predict that there will be an increase of at least 10% in new tax litigation in each of the next three years. The combination of high tax rates and peak business activity are factors likely to produce increased litigation, along with the legal problems growing out of the Korean war excess profits tax law and the 1954 Code."

Mr. Rice also commented on the great increase in the dollar volume of new tax litigation. He said that in 1947 the average new case received in the Division involved $60,000, whereas today

the average new case involves $148,000. As a result, he said that the total amount involved in civil tax litigation in the Department has grown to nearly $700,000,000.

On the criminal side, Mr. Rice said that more convictions were obtained in the first six months of 1957 than in any comparable period in the Department's history. Referring to the close teamwork between the Department of Justice and the Internal Revenue Service in the development and prosecution of such cases, he said that the results obtained in 1957 clearly reflect the stepped-up activity of the Service in the tax evasion field. He added that it is reasonable to expect that an even larger number of cases will be referred to the Department of Justice in the next two or three years.

Ways & Means Committee to hold broad tax revision hearings in January

TAX PRACTITIONERS are invited to present their views on revision of the tax laws at hearings to be held by the Ways & Means Committee in Washington beginning January 7, 1958, Jere Cooper, chairman, has announced. This is the first hearing on general tax revision since 1953.

"I feel that it is most important for the Committee to give the Treasury Department and taxpayers an opportunity to appear before the Committee in public hearings and testify as to any problems which their experience may have developed under the application of the 1954 Code," Mr. Cooper said. "In addition, I feel that the Committee should give taxpayers an opportunity to appear and testify on general tax revision, including the effect and distribution of present tax burdens. There are pending before the Committee some fifteen hundred bills, the great majority of which are tax measures. Individuals, organizations, and associations are very interested in having hearings held on these various proposals. The hearings will be broad and general and, of course, will also cover any specific proposals, on which the interested public may desire to comment. It is my hope that by making this announcement well in advance of the scheduled hearings interested persons will devote time and study to tax revision and give the Committee the benefit of their recommendations and suggestions."

Where to submit requests

Persons and organizations interested in appearing and testifying should submit their request to the Clerk of the Committee, 1102 New House Office Building, House of Representatives, Washington, D. C., by December 2, 1957. In those cases where witnesses desire to comment on specific provisions of the Code, it is requested that their testimony be so organized as to set forth the specific provisions on which they plan to comment. The prepared statements should contain topical headings and subheadings indicative of the points to be made in the text and refer to the specific sections of the Code to which testimony is directed. It is also requested that the prepared statements be arranged in topical order identifying the particular subject to which the statements are directed. This will permit the Committee and the staffs to readily cite testimony to specific provisions of the Code and the particular subjects to which testimony is directed. It is requested that a brief digest of the testimony be set forth on the concluding pages of the statements. ☆

Why the IRS doesn't acquiesce or appeal all decisions

COMPLAINT that the Commissioner nonacquiesces in some decisions of the Tax Court was registered by the Practitioners Advisory Group to the Mills Committee recently [See 7 JTAX 31]. The practitioners want the IRS to either acquiesce or appeal in every case.

Now Fred C. Scribner, Jr., Assistant Secretary of the Treasury, explains that this situation is not all that meets the eye. He told the Tax Section of the American Bar Association in New York recently that (1) there are very few non-acquiescences, and (2) there is good reason for them.

In 1956, he said, 88% of Tax Court decisions the Commissioner lost were acquiesced, 8% were appealed, leaving only 12 cases neither appealed or acquiesced.

The chief reasons for these few being non-acquiesced, he said, were either that Regulations were in the works covering the point, that legislation might be pending which would cover the point, or that the IRS had actually wanted to appeal but had to abide by the decision of the Department of Justice, which had final authority and its own reasons for not wanting to appeal a particular case with its particular facts.

New procedural decisions this month

Refund claim relied on wrong contract. Several taxpayers were parties to a series of contracts as they changed their methods of exploiting a patent on the invention of one of them. The inventor himself based his claim on a 1949 agreement and is allowed capital gain on the ground that the transfer there was a sale. Others presented only a 1946 agreement in their claim for refund. The court holds they may not offer the 1949 agreement in the suit; it would be a ground not presented in the claim. *Gruber,* DC Ore., 5/31/57.

Actual owner of stock in street name must itemize dividends. The record owner of stock who is not the actual owner, for example brokers in whose name customers' stock is held, must report the actual owner and amounts of dividends received. Though that report need not itemize the receipts, the owner must itemize the dividends on his income tax return. *Spec. Rul.* 7/11/57.

IRS won't testify in private litigation. The Regulations provide that Internal Revenue officers may not, without permission of the Commissioner, testify about facts they learned in their official capacity. Authority to testify will not be given in litigation which does not concern the Government. *Rev. Proc.* 57-24.

Appellate Division jurisdiction extended to excise and employment tax cases. Procedures for protests and conferences before a Regional Appellate Division in unagreed excise and employment tax cases has been revised and made uniform with income tax administrative appeals procedures. *Rev. Proc.* 57-26.

INCOME TAXATION OF

Trust & estates

Some pitfalls to avoid if you seek advantage from short-term trust

by **HOWARD O. COLGAN, JR.**

The short-term trust rules in the 1954 Code were hailed as making simple and certain this powerful family tax saving device. Mr. Colgan, writing in the Trust Bulletin, evaluates the new rules in view of the passage of time, and finds them still good. His comments, excerpted below, will help the expert weigh the highly technical points and the generalist to think constructively about the use of such trusts.

THE INJECTION of provisions into the Internal Revenue Code relating to the income taxation of short-term trusts caused many to rush into print. The tax advantages which were hailed were legion. It seems a good idea, after two years, to tap the keg again to see whether after a time for reflection the wine still seems so sweet.

The short-term trust provisions which prompted the original flurry are the provisions in Section 673 under the caption "Reversionary Interests." Broadly paraphrased, they say three things. First, the grantor is to be treated as the owner of a trust in which he has a reversionary interest in corpus or income if such interest can be expected to revest in him within ten years from the date of the transfer in trust. Of course the attraction here is in the implication that there is clear income tax sailing if the reversion to the grantor cannot occur within the ten-year period. Coupled with this main provision is the subsidiary provision in Section 673(c) that the grantor is in the clear if his reversionary interest will not take effect until the death of the person to whom the income is payable, with the implication springing from this that even though the income beneficiary is not long for this world and certainly not for ten years, all is well with the grantor of such a trust. And finally, there is the two-year giveaway encouragement of Section 673(b) which puts in the clear a trust in which the grantor has a reversionary interest but the income is payable for a period of at least two years to a beneficiary which is either (a) a church or a convention or association of churches, or (b) an educational organization having a regular faculty, curriculum, and student body, or (c) a hospital.

Except for the last-mentioned provision relating to two-year charitable and educational trusts, none of these provisions on short-term trusts actually represents a very drastic departure from the pre-1954 law. Their appeal and their virtue lie more perhaps in the fact that they represent the importation of some certainty of result in an area which has been unsettled and subject to a great deal of backing and filling for the fourteen years that had elapsed since the decision in *Helvering v. Clifford*.[1]

The change in the law from the "Clifford" provisions in the Regulations to the 1954 Code Sections did not represent a too startling transmogrification. The old ten-year rule was retained; the fifteen-year rule was dropped; the narrowly proscribed two-year rule on charitable trusts was added. The permissible measurement of a reversionary trust by the life of the income beneficiary is also a carry-over from the 1939 Code.

Against this background we may weigh the advantages and disadvantages in short-term trust tax planning. The chief disadvantage may be gift tax cost. We'll return to that later. Let's look first at the advantages.

It may be well to list first some of these heralded advantages and then take them up in more detail. These are not original with the author. They have been drawn from a number of sources including those listed in the bibliography at the end of this article and their mention does not imply endorsement:

1. Shift income from high surtax brackets to much lower rates.
2. Accumulate income in trust for wife for ten or fifteen years in low bracket of a trust, then pay it over to her.
3. Use income of trust to support relatives or adult dependents.
4. Provide educational fund for minor children.
5. Use trust income to buy insurance on children or grandchildren.
6. Use trust income to buy insurance on wife's life with proceeds being used to buy assets from wife's estate.
7. Use trust income to purchase an annuity for relative or friend.
8. Borrow money and use for creating short-term trust.
9. Provide a dowry for a daughter or for getting a child started in business or creating a house-buying fund for children by accumulating income in trust and paying it to them at 21.
10. Transfer a capital interest in a partnership to a trust.
11. Transfer a business to a short-term trust.
12. Accumulate income for a child's professional education.
13. Take advantage of a $300 annual exemption where the fiduciary is required to distribute the income currently.
14. Build a retirement fund through a fifteen-year accumulation trust for a wife who invests the accumulations in a single premium annuity.
15. Provide an educational fund for young children by using income of a short-term trust to buy a ten-year endowment policy on one child and a fifteen-year endowment on the younger.

All of these useful suggestions must be tested against other Code sections than Section 673 to make certain that the grantor will stand in the income tax clearing. Section 673, which as noted

earlier provides the framework for short-term trusts with reversionary interests, is a part of Subpart E. Section 671 (also in Subpart E) provides that no items of a trust shall be included in the grantor's income "solely on the grounds of his dominion and control over the trust under Section 61 or any other provision of this title except as specified in" Subpart E. This rules out all of the pre-1954 worries as to whether a trust may be classified as a Clifford trust because of its term or its term combined with administrative powers retained by the grantor. Generally speaking, if the grantor's powers meet the tests of Section 674 relating to "power to control beneficial enjoyment" and Section 675 relating to administrative powers, then the trust need be tested by no other standards if its term is for ten years or the life of the beneficiary. But like most rules of taxation, there are exceptions to this one.

Trust for dependents

If the beneficiaries are dependents of the grantor, an eye must be cocked at Section 677. There it is provided that the grantor shall be treated as the owner of a trust if the income may be "distributed to the grantor" or "held or accumulated for future distribution to the grantor." This provision is in substance the same as Section 167(a) of the 1939 Code, and in Section 677(b) is the counterpart of Section 167(c) of the 1939 Code. This last-mentioned Section provides that the income of a trust shall not be taxed to the grantor merely because it may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that the income is so applied or distributed.

If the trust is one for the benefit of individuals whom the grantor is under no obligation to support, there is no income tax problem if the trust is to continue for the required period, and if the grantor has retained no powers of control there is of course no problem under Section 677. The trust for old family retainers or non-dependent relatives or friends will create no problems. Suggestions for employment of the short-term trusts for the benefit of those in a close degree of relationship, however, must be posed against the legal obligation to support-or-maintain test in Section 677. The question of what constitutes support and maintenance within the scope of the grantor's legal obligation is one which requires resort to state law for its definition where minor children are involved. Where adults are involved, such as a mother or father, local law must be looked to to determine whether any obligation is imposed on the grantor son or daughter for their support. These are important considerations before rushing pell-mell into the arms of a short-term trust which offers on its face the charm of getting income into lower tax brackets for a number of years and having the corpus return to the fold of the grantor at the end of that time.

In many jurisdictions it is still largely unsettled as to whether a father owes his children anything more by way of an education than one at a public school and possibly also a state university. If the trust provides for their education at a private school or college or a professional school, or provides funds to maintain a car or join a fraternity, are these items in the support and maintenance category or are they pure luxuries so that the father should not be taxed on the trust income which provides them? The trend, at least in New York, seems to be more in the direction of permitting wider education opportunities to fall within the support and maintenance category and the same may be true in other jurisdictions. The local rule is apt to have its variations too, based upon the income level of the parent obligated to support the minor. In the higher strata, fraternity dues or a car at college might almost be viewed as a matter of normal maintenance. In other brackets, the devotion of trust income to these ends would indeed be a luxury and beyond the scope of normal support and maintenance. For the sake of father's tax return, the college-going son or daughter who derives his income from a short-term trust may have to provide a more exact accounting of just where the money went. It is a sufficient caveat to suggest that local law should be carefully investigated before the potential grantor runs too fast to a short-term trust for the education of his children.

These same considerations arise in the case of a short-term trust for a parent with reversion to the grantor. The son who has been helping out by monthly payments to a retired father out of his income taxed in the high brackets will think it a fine thing if he can put some of his securities into a short-term trust with the income to go to his parents and be taxed to them at a much lower rate. If local law imposes no duty of support on the son or if the parents have income sufficient for their basic support, then a short-term trust for parents can indeed be a useful device but it should not be rushed into without careful investigation.

Again the short-term trust can be a useful thing where the grantor wishes to provide for an elderly former employee or family retainer. Even here, however, the income could be taxed to the grantor if it was being used to discharge a contract obligation to pay a pension to the former employee and the adviser of the potential grantor will make inquiry in advance as to whether such a condition exists.

In those jurisdictions which, unlike New York, permit an accumulation of income for periods longer than the minority of a beneficiary, the short-term trust will find better soil for its establishment. The possibilities are infinitely greater for its employment in connection with (1) the payment of insurance premiums on policies on the lives of the grantor's wife or his children or grandchildren[2] which are owned by the trust or someone other than the grantor and which are either payable to children or grandchildren or which are to be turned over to them on termination of the trust or (2) the accumulation of income for a wife or child for the trust term.

Caution

Several words of caution are in order. Under Section 677 a grantor is treated as the owner of a portion of a trust whose income is or in the discretion of the grantor or a nonadverse party, or both, may be applied to the discharge of a legal obligation of the grantor, to the extent that the income is actually so applied or distributed. It should be

[1] 309 U.S. 331 (1940).

[2] Use of trust income to pay premiums on policies insuring the life of the grantor will, of course, run afoul of Section 677.

[3] *"Savings Income Taxes by Short-Term Trusts,"* Olson and Gradishar, Prentice-Hall, Inc. 1956.

[4] Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Dist. of Columbia, Florida, Georgia, Hawaii, Idaho, Indiana, Kansas, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, N. Hampshire, New Jersey, New Mexico, New York, N. Carolina, N. Dakota, Ohio, Oklahoma, Penna., Rhode Island, S. Carolina, S. Dakota, Tennessee, Texas, Utah, Vermont, Virginia, W. Virginia, Wisconsin, Wyoming.

[5] Section 170(b)(1)(D).

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noted, however, that even in the case where the trust income is not used to discharge a grantor's legal obligation, the grantor may be creating an income tax problem for someone else, such as the parent of a minor child or a son who has dependent parents if the trust income is to be used for the benefit of the minor child or the dependent parents.

Any trust, whether it be short term or long term, whose income may be employed for the support or maintenance of a beneficiary whom someone is obligated to support must be measured against the regulations which have been proposed under Section 662 which provide in part: "§ 1.662(a)-4 *Amounts used in discharge of a legal obligation.* Any amount which, pursuant to the terms of a will or trust instrument, may be used in full or partial discharge or satisfaction of a legal obligation of any person shall, to the extent so used, be included in the gross income of such person under Section 662(a)(1) or (2), whichever is applicable as though directly distributed to him as a beneficiary, except in cases to which Section 215 or Section 682 applies. . . ."

The above-quoted Section goes on to attempt to state a definition of the term "legal obligation" in a frame of reference to local law. ". . . If under local law a child is obligated to support his parent only if the parent's earnings and resources are insufficient for the purposes, no obligation exists. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. Normally, in the case of a parent's obligation to support his child, the extent of the parent's legal obligation of support, including education, will be determined by the family's station in life and by the means of the parent without consideration of the trust income in question."

Without going into an extended discussion of the above-proposed Regulation, it is sufficient to note that education trusts for minors, no matter by whom created, and trusts for parents of inadequate means must all be carefully weighed to see whether beneath the beneficence that is on their faces there may not be a hidden tax trap for the parent of the child who is the beneficiary or the child of the aged parents whose legal obligation may be discharged by way of the trust income.

The gift tax cost may well be the primary disadvantage of the creation of a short-term trust. In most cases the burden will prove more theoretical than real when measured against the income tax savings which are possible. A recently published book[3] contains a large number of tables showing the income taxes saved annually by taxpayers in various brackets through the creation of short-term trusts and the shifting of income to the trust beneficiary or to the trust. The same book contains a table showing the gift taxes to be paid upon creating a ten-year trust with reversion in the grantor.

Some writers have also mentioned the estate tax saving possibilities of a short-term trust. Such savings, however, are not truly of significance and certainly cannot be viewed as an estate planning device. If the grantor dies during the period when the short-term trust is still in existence the value of his reversionary interest will be included in his gross taxable estate. If the trust still has nine years to run when the grantor dies, only about 73% of its value will be included with this percentage rising to over 96% where the trust has only another year of life. Most potential grantors interested in retaining a reversionary interest feel confident that the property is going to return to their hands. Death and estate taxes will, therefore, seem terribly remote and they probably will not be easily persuaded to linger long over the estate tax savings even though such a possibility does exist.

Gifts to minors

Where the gift contemplated is to a minor and the amount is relatively small, donors might do well to contemplate the comparative advantages from a gift tax standpoint of foregoing the retention of a reversionary interest and making use of two new statutory provisions. Under Section 2503(c) which was added in 1954, a $3,000 gift tax exclusion is available if property is transferred in trust for the minor and the property and income therefrom may be spent by, or for the benefit of, the minor before he reaches 21 and to the extent not so expended will pass to the donee at 21 or, if he dies before then, will be paid to his estate or as he may appoint under a general power of appointment. The same result may be achieved through an outright gift made under the newly enacted gifts to minors statutes sponsored by the New York Stock Exchange which have been adopted in forty states and the District of Columbia thus far.[4] Under these statutes no formal trust instrument is requisite and registered securities are merely carried in the name of a member of the minor's family as "custodian" for the minor with a reference to the applicable statutory provision. Bearer securities require the execution of a simple form of deed of gift.

Two-year charitable trust

The two-year charitable trust is not an estate or gift tax saving device. Its usefulness lies wholly in the income tax field. Here its utility in turn lies on the side of the taxpayer whose regular charitable and educational giving might exceed the limitations of the charitable deduction (20% of adjusted gross income with an additional 10% for contributions to churches, educational institutions, and hospitals). It is useful also for that individual who, somewhat on the conservative side and not entirely certain about the future, does not wish to part permanently with his capital but still would like to see his favorite charity assured of the receipt of a substantial amount over the next several years.

But several cautionary notes should be sounded. The beneficiary of the two-year charitable trust must be a single church, a single hospital, or a single school or college. A trust whose income is to be divided among Amherst, Williams, and Wesleyan, for example, will not qualify. Separate trusts for each must be created. This seems a nonsensical restriction which should be cured by statutory amendment but, for the present, it must be lived with. Note also

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that there is no income tax deduction available for the present value of the income interest of the charitable beneficiary unless the grantor's reversionary interest is 5% or less of the value of the trust.[5]

Finally, mention should be made of the treatment of capital gains realized by the trustee of the short-term charitable trust. In most states capital gains are required to be added to corpus unless the trust instrument provides otherwise. They are, therefore, distributable to the grantor in the ordinary case when the trust reverts to him. While Section 673 indicates that the grantor is not to be taxed on trust income if it is payable to a charity for more than two years, still Section 677 must not be lost sight of. That Section provides that the grantor shall be treated as the owner of any portion of a trust whose income may be distributed to the grantor. Hence the capital gains would probably be taxed to the grantor and not to the trust even though the reversionary interest was sufficiently remote as to prevent the ordinary trust income from being taxed to him. If the grantor wishes to avoid this result, specific provision should be made in the trust instrument for distribution of realized capital gains to the charitable beneficiary or to someone other than the grantor, either currently or on termination of the trust. In the latter case, the gains would be currently taxed to the trust (with a $100 exemption available against them) except in the year of termination when they would be taxed to the beneficiary to whom such gains were then distributable. ☆

New trusts & estates decisions

Income in respect of a decedent treated as corpus to distributee. Taxpayer's husband's will provided that his residuary estate be set up in trust for her benefit. Rentals accrued but unpaid at the date of death were included as an asset of his estate. The court holds that the rentals, when collected, although includible in the trust's gross income as "income in respect of a decedent," are not to be included in the gross income of the wife as a distribution of income. The court follows its own decision in *Huesman,* 16 TC 656, affirmed on other grounds, 198 F.2d 133, that Section 126 makes no provision for taxing income in respect of a decedent to anyone but the recipient (here the trust). The court also holds that $5,000 withheld from distribution by the trustees as a "reserve for repairs," and $2,000 withheld as a "reserve for trustees' commissions" as determined by a state court, properly withheld and being unavailable to taxpayer, are not distributable income and accordingly should not be included in her income. *Carruth Estate,* 28 TC No. 95.

Estate had IT deduction for litigation cost to obtain property. Deceased had been the beneficiary of a trust under her mother's will, the principal going to charity at her death. However, the decedent's estate (taxpayer here) brought suit to have the gift to charity declared invalid and the principal paid to them. The litigation was successful and the taxpayer-estate collected corpus (some $470,000) and income $(115,000) was added to the taxpayer-estate. The court says that the expense is a cost of administrating the estate, which the Regulations themselves allow. The Commissioner ruled that only $115,585 of the legal expense could be deducted. The rest, he said, was cost of the property acquired, since the litigation was in the nature of a defense of title. This case is essentially similar to *Bingham* (325 U. S. 36) in which a trust was allowed to deduct the cost of litigation. *Keller Estate (Loyd, Ex'r),* Ct. Cls., 7/12/57.

Life tenant is entitled to portion of windstorm damage. [*Acquiescence*]. A severe storm caused damage to the trees, shrubs and hedges on property in which taxpayer held a life estate. The loss amounted to $31,000. Of this amount, $1,300 represented the sum expended to remove the debris, and $30,000 represented the damage to the property. The Commissioner of Internal Revenue allowed taxpayer a deduction of only $1,300. The Tax Court holds taxpayer should have also been allowed some portion of the $30,000 since the damage was an injury to the life estate as well as to the remainder interest. The additional deduction was calculated by allocating the $30,000 on the basis of the actuarial tables referred to in the estate tax Regulations. *Bliss,* 27 TC 770, *acq.* IRB 1957-29.

No charitable deduction; distribution withheld pending litigation. Decedent had by will exercised a power of appointment by creating a trust of the appointive property in which charities shared in income. Certain relatives began litigation contesting the validity of the exercise of the power and the local court ordered income accumulated pending adjudication. For 1952, the year in issue, the trustee made no distribution to charity and claimed no deduction for charitable distribution on its income tax return. It now argues that was in error because the litigation was settled in 1954 by a high court determination that the charity was entitled to part of the 1952 trust income. Noting that this precise question seems not to have been previously presented, the court holds that a charitable deduction is not allowable because nothing was "paid or permanently set aside' (Section 162(a)). The court points out that that phase, applicable to charities, differs from the phrase allowing a deduction for distributions to beneficiaries of amounts "to be distributed currently." If the distributee here were a beneficiary, the trustee would be allowed to deduct the amount ultimately determined to be distributable. Since the distributeer is a charity, it may not. *Walker Trust, (Fidelity Tr. Co., Tr.),* DC Pa., 6/17/57.

New estate & gift decisions this month

No charitable deduction though sole beneficiary died leaving all to charity. A husband and wife executed reciprocal wills. Each left the entire estate to the other, if surviving, if not the entire estate, after certain bequests, was to be paid to a charitable trust. The husband died first and during the period of administration the wife died. The husband's estate claimed a charitable deduction for all the income of the estate subsequent to the wife's death since it would ultimately go to the charitable trust. The court does not allow the deduction. The charitable deduction is only available when it is the decedent's will that commits the income to charitable purposes. *Williams,* DC Cal., 3/28/57.

Annuity to wife reduces formula marital deduction; valued on wife's actual physi-

cal condition. Decedent's will bequeathed to his wife assets from his probate estate equal to one-half the adjusted gross estate (for estate tax purposes) less assets forming part of his taxable estate but passing to her outside his will. Unlike the usual marital deduction formula clause "outside assets" were not limited to outside assets which qualify for the marital deduction. Thus the value of certain annuities passing to the wife because of provisions in the policies reduced the bequest although they were terminable interests and do not qualify for the marital deduction. In valuing the annuities, the wife's actual life expectancy based on medical prognosis was considered: she had incurable cancer and died about a year after decedent. *Hoelzel Estate,* 28 TC No. 41, 5/17/57.

Transfer by near octagenarian not in contemplation of death [*Acquiescence*]. Approximately one year prior to her death, decedent, then aged 79, transferred $500,000 to her daughter, partly outright and partly in trust. This sum represented about one-seventh of her estate. In finding that the transfer was not in contemplation of death, the Tax Court stressed her apparent good health and the recognized longevity of her family. Perhaps the crucial factor, however, was the testimony of her attorney, who indicated that the purpose of the transfer was to save income taxes, a purpose which by its nature contradicts any assumption of contemplation of death. *Sheldon Estate,* 27 TC 194, *acq.* IRB 1957-25.

Allocation made to determine refund under Technical Changes Act for compromise settlement of reverter and other issues. In *Spiegel* (335 U. S. 632), the Supreme Court required inclusion in the gross estate of certain life-time transfers in which the decedent retained a reversion, no matter how remote. To relieve the harshness of this decision, Congress permitted, in Section 7 of the Technical Changes Act of 1949, refunds of tax paid because of a remote reversionary interest. The taxpayer-estates had cases before the Tax Court at the time of the *Spiegel* case in which the Commissioner asserted tax on the property transferred because (1) a reversion was retained and (2) the transfer was in contemplation of death. The cases were settled by stipulation that $20,000 was owing; no grounds for the deficiencies were stated in the settlements. The taxpayers here sued for refund of the deficiencies. In its original opinion the court denied relief because taxpayers did not show how much was paid by virtue of the reverter issue. On rehearing, however, a majority of the court decides to allow 50% relief as a means of doing substantial justice. *Roberts Estate,* Ct. Clms., 6/5/57, *Heater Estate,* Ct. Clms., 6/5/57.

Notes on new estate and gift decisions in this department are by Edward P. Hanigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

Irrevocable life insurance trust not created in contemplation of death [*Acquiescence*]. Some fourteen years prior to his death in 1949, decedent created an irrevocable life insurance trust for the benefit of members of his family. The sole string retained by the decedent was certain powers of management over the trust property. The proceeds of the policies were not, the court held, includible in his gross estate as the subject of a transfer in contemplation of death. His avowed motive for making the transfer was to insulate the insurance policies from the risks of his speculative business enterprises. Neither were the policies includible under the premium payment test of the 1939 Code; the decedent had ceased paying the premiums after January, 1940. Nor were the retained powers of management sufficient to impute to the decedent any of the incidents of ownership in the policies. *Mudge Estate,* 27 TC 188, *acq.* IRB 1957-25.

Half of joint securities includible in husband's estate; wife had purchased one-half [*Acquiescence*]. In the same case in which it was held that transfers of securities between a husband and wife under an oral profit-sharing agreement were not taxable gifts, the question of the inclusion of the jointly held securities in the husband's gross estate was in issue. Only one-half the value of such securities was held includible, as this was the whole extent of the husband's interest. The transfers under the agreement had created a tenancy in common under Maine law. Although the wife may have permitted the husband to retain sole dominion over the securities jointly held, such permission was purely voluntary. The wife at all times was the owner of an undivided one-half interest in the property. *Trafton,* 27 TC 610, *acq.* IRB 1957-25.

Estate of donor-custodian includes gifts under new custodian law. The IRS rules on the estate tax aspect of gifts to minors under the law recently adopted in many states providing for a custodianship of securities so given. The Ruling discusses the model act which provides that the custodian holding securities for the benefit of a minor may in his discretion apply the income and principal of the securities held for the general use of the minor. Should a donor transfer property to himself as custodian for a minor donee, he would, as such custodian, possess this power to pay or to withhold both income and principal. As a consequence, the property would be included in his gross estate in the event of his death while acting as custodian. *Rev. Rul.* 57-366.

Gambler's opening net worth must be clearly established. Deceased taxpayer ran two legitimate businesses operating at a loss and also the "revolting, but profitable, illegal Bolito, Cuban numbers racket." In determining the taxpayer's net worth for the year 1947, the Commissioner and the Tax Court made the assumption that, absent other proof, the opening and closing cash position remained constant. The record shows that the taxpayer had hoards of cash from which the closing assets could have been derived; moreover, the alleged profits belied the assumption of a constant small cash balance. The Commissioner cannot fix the opening position from the closing figure arbitrarily. This would turn the net worth method into a sham, lending a semblance of logic to sheer guesswork. *Phillips Estate,* CA-5, 7/16/57.

Grantor's power to invade not unlimited; trust not in his estate. The Commissioner contended that the enjoyment of the property transferred in trust by the decedent was subject to a power in the decedent to alter the beneficial enjoyment. The court holds that the decedent's power of invasion of the trust corpus for the income beneficiaries' support and maintenance was subject to a fixed external standard which sufficiently circumscribed his discretion. His power to determine what was principal and what was income was merely an ad-

ministrative provision which could not be exercised arbitrarily. Consequently the trust is not includible in the grantor's estate. *Goyette Estate,* DC Calif., 7/12/57.

State death taxes paid deductible although final tax not fixed. The executors of an estate had made a payment to the state of estimated inheritance taxes due. The inheritance tax, although not actually fixed, would exceed 80% of the Federal basic tax, the maximum allowable as a credit against the Federal tax. Consequently, the court holds that the estate is entitled to the credit for state death taxes actually paid. *Goyette Estate,* DC Calif., 7/12/57.

Net effect of trust amendments determines whether there has been a tax-free partial release of general power of appointment (Old Law). Taxpayer was income beneficiary of five trusts set up by her husband and possessed the power to alter, amend, or revoke each. Upon revocation, the principal would be disposed of according to her directions. The taxpayer amended the trusts by providing for certain changes in the interests of the remaindermen (all of whom were her children) and by reducing the scope of her future authority to a power to direct the trustee to make charitable contributions out of income or principal. Still later, this last power was released. The Commissioner argued that the amendments constituted the exercise of a general power of appointment and consequently a taxable transfer under the 1942 Revenue Act. The taxpayer argued that it was a mere reduction of a general to a specific power, and therefore exempt. The court holds that the substance of what the taxpayer did was the precise equivalent of a reduction of a general power to an exempt special power, followed by the exercise of the special power. The statutory object is to protect from taxation a donee of a power who disables herself from exercising a power for the economic benefit of others than those in the specified class. Despite the unfortunate chronology of events, this in substance is what the taxpayer did. Consequently, there was no taxable transfer within the meaning of the Act. *Emery,* DC Mass., 6/24/57.

No charitable deduction; standard for invasion inadequate. Decedent bequeathed her entire residuary estate in trust to a 71-year-old female servant for life, with the remainder to charity. The trustees were authorized to invade principal at their discretion "for the best interest" of the life beneficiary "during illness or emergency of any kind." The charitable deduction for the remainder interest is denied on the ground that its value cannot be ascertained. The will furnished no yardstick to measure the extent of the coverage of the phrase "for the best interest" of the beneficiary and the phrase "emergency of any kind" embraces a multiplicity of conceivable situations the possible expenditure for which cannot be forecast. Consequently, the extent of invasion of principal is not measurable by a standard at the date of death and, as would follow, neither is the value of the remainder interest. *Bartlett Estate* DC Pa. 7/30/57.

Tranfers between husband and wife under oral profit-sharing agreement not gifts [*Acquiescence*]. A husband and wife had together engaged in various business activities during the forty-five years prior to his death under an oral agreement whereby all earnings were to be owned by them jointly. Transfers of securities were made by each individually into their joint names at various times. To the extent such transfers were pursuant to the profit-sharing agreement, there was ample consideration in money or money's worth and consequently no taxable gift. Some of the securities placed in joint ownership by the wife, however, were traceable to her independent estate. Since these transfers were not governed by the agreement, there was no consideration and the transfers were taxable. *Trafton,* 27 TC 610, *acq.* IRB 1957-25.

No estate tax on bank account of nonresident alien. Securities revocably transferred to foreign foundations by the decedent, a non-resident alien, but in the possession of American banks were includible in the gross estate of the transferor. In addition the Commissioner contended that the cash on deposit with the banks in the name of the foundations was likewise includible. The Court holds that when money is deposited either by a non-resident for the benefit of himself or a third person, or by a third person for the benefit of a nonresident, the deposit is deemed to be situated outside the United States and exempt from the estate tax. Here, the cash was deposited by a non-resident, either for his own benefit or for that of his children and the exemption is consequently available. *Swan Estate* CA-2 7/29/57.

Revocable transfers to foreign foundations included in gross estate. The decedent, a non-resident alien, established two family foundations in Leichtenstein and Switzerland to provide for his children. The securities and cash transferred were on deposit in an American bank. The decedent could withdraw moneys and amend or terminate the foundations at any time. The Court holds that the fact that the foreign foundations (called Stiftungs) may have possessed characteristics making them more closely akin to corporations than to trusts is not determinative. Regardless of the unusual mode of the transfers, they were nonetheless revocable by the decedent, and consequently, the value of the foundations' holdings in securities, which had a situs within the United States, is includible in his gross estate. *Swan Estate* CA-2 7/29/57.

Gift and lease-back didn't shift income tax but gift tax is payable. In a prior Ruling (5409, Cum. Bull. 1954-1, 20) the Service held that a transfer of real property in trust for a ten-year period for the benefit of the grantor's children with a lease-back to the grantor was a transfer in form rather than substance, and that the grantor would remain the owner of the property during the term of the trust for the purposes of Federal income and gift taxes, and each payment of rent would be a gift to the trust when made. The prior Ruling is now modified to the extent of providing that a completed gift is made at the time of the transfer, the value of which is the present value of the future rentals from the property during the term of the trust. The fact that the donor remains taxable on the income from the property transferred does not of itself make the transfer incomplete for gift tax purposes. *Rev. Rul.* 57-315.

Request for prompt assessment must be transmitted in separate envelope. The Service holds that a request for prompt assessment of tax by the executor or administrator of an estate of a decedent must be a separate document filed after the return in question and must be transmitted to the District Director in an envelope separately from any other document. *Rev. Rul.* 57-319.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

How to make professional office filing, bookkeeping systems, reliable, easy to use

by **RALPH R. NEUHOFF**

Good filing and record-keeping systems make all the difference between a happy, efficient tax practitioner's office and a chaotic, vexatious mess. While this article is written for a law office, it does, of course, apply equally well to most accounting offices. The heart of this author's excellent advice is "Use the experience of others," "don't improvise," and "do it well but don't knock yourself out trying to be impossibly perfect." This is the first of a series of two articles.

MODERN INDUSTRY has made great strides in labor-saving office technique. The problem of the tax practitioner in office management is not to invent new techniques, but to adapt to his circumstances the techniques which have already been developed. This approach will be valuable because it will enable him to tap the experience of thousands and even hundreds of thousands of persons instead of a mere handful who have devised professional office systems as such. It would be difficult to try to tell you briefly how to keep a lot of records, especially if you are not to keep them personally, but would have to tell someone else who will actually keep them. But it is quite possible to explain how to go about tapping the experience of the persons who really know office management. We refer here to industrial accountants, not lawyer amateur accountants. Our purpose is to use what other people in other fields have done and thought out to solve the particular problems of a lawyer in a law office.

Before entering upon this, however, it might be well to discuss the "my business is different" complex. At meetings devoted to industrial accounting and management, one frequently hears from businessmen a remark along the following lines: "The talk was good, but my business is different and I cannot use anything that he has said."

Naturally this could be so as to some people, but it hardly could be so as to all who claim it. Let us settle for this: Even if your business is "different," that fact furnishes no reason why you should not use business principles to solve your business problems. However, because it must be conceded that the business of a lawyer, so far as concerns his management of his office, differs considerably from industrial business, we shall emphasize principles rather than particular methods.

We will discuss here only filing systems and bookkeeping systems. Cost-finding systems will be covered here next month. Therefore, we shall exclude from the scope of our discussion such things as: offices, including receptionist, telephones and equipment; library; client relationship; public relations; and partnership relations. This is not because the last-mentioned subjects are not important, but simply so that we may deal more in detail with the particular subjects chosen for discussion.

Some preliminary basic principles

Keep it typical. It is desirable for a tax man to keep his systems "typical," that is to say, to use what others have found out in industry. Don't be ingenious! Don't improvise! Many of the systems which have been published on law-office management may be a great tribute to the ingenuity and inventiveness of their authors, but they utterly disregard the experience of thousands and thousands of businessmen and fall into errors which have been discovered and eliminated years ago by industrial accountants and office management experts.

Learn to walk before you learn to fly. There is hardly anything so distressing as a system which doesn't work. For this reason it is quite advisable not to introduce refinements, especially shortcuts, until you are ready for them. The volume of the operations in a law office is not great, and many shortcuts do not produce enough saving of time to justify the complications which are involved in them. For successful operation, what you do not do is quite as important as what you do do. You must be alert to scrap relentlessly any step or operation which you have introduced or which anyone else has introduced into your law office which does not justify itself. A law-office-management system is not an end in itself, but is a means to an end. On its own account it is not important at all. It is only important in the results which it produces.

Every operation involving figures should be capable of being checked to determine errors. Probably the best way to check is by the balancing of totals. This is the time-honored method used by businessmen. A double-entry bookkeeping system does this. We shall have more to say later about the double-entry system, which, as you know, has very little acceptance in law offices at the present time.

Do not disdain mechanical aids. We have reference here to such things as: loose-leaf ledgers rather than bound-book ledgers, ruled forms, carbon copies and things of this nature. Whatever has been widely adopted by businessmen and is adaptable to the peculiar conditions of a law office may be useful to you. It is advisable to haunt the business shows which are put on frequently by office-appliance and other people to see if there is anything which could be adapted to your conditions.

Do not attempt to tie in substantially unrelated matters. We should refrain from any attempt to tie in matters which, although they have a bearing on one another, are not substantially related. Therefore, it is recommended that we do not attempt to tie in: (a) the filing system, (b) the bookkeeping system, and (c) the cost system. Some published systems appear to tie in the book-

keeping system and the filing system, and it would, of course, be possible to tie in all three of these. But this would introduce difficulties that are unnecessary. There is an axiom in law-office management as follows: "Don't manufacture trouble for yourself."

The filing system

The purpose of a filing system is to police the flow of work through the office. This may come as a surprise to some who had the opinion that the purpose of a filing system was to file papers systematically so that they could be conveniently found. The latter, of course, is a primary purpose of any filing system, but it is so rudimentary that it is better, I believe, to consider the filing system as the means whereby you control or supervise the work which has to be done for clients by the law office.

Each task upon which professional responsibility is incurred should be represented by a file. This might result in a few instances in having a file with no papers in it, at least temporarily. It would still be necessary, if such a situation should arise, to have a file to represent the fact that the professional responsibility had been undertaken on a certain task. Almost inevitably, however, there would develop papers which should go into that file.

The file should have a definite identity, which is best accomplished by giving it both a number and a name. Here we shall discuss some things which are not fundamental and which can be varied without violating any of our basic principles. Let us take for granted that the purpose of giving names to files is to enable them to be easily located in an index. It, therefore, would be a good rule to have, first, the number of the file, second, the name of the client of the office, third, the name of the adverse party, and, fourth, a catch-word as to the kind of business represented. This might result for example in inverting the order of names which appeared in a lawsuit. For instance, the case of Jones v. Smith would not be listed that way on the file if Smith happened to be the client of the office. Rather the file would be: "1234 John Smith: James Jones—Ejectment."

When we index this file we would have a numerical list in sequence for the numbers and a card for each of the three other elements given above, all of which cards would be filed alphabetically in one series. As a result, if you knew the name of your client you could find the file, if you knew the name of the adverse party, you could find the file, and if you desired to find all of the cases which the office had handled involving ejectment principally, you could find all of those cases.

There should be a distinction between "open" and "closed" files. An open file is one where professional responsibility continues and a closed file is one where professional responsibility has ended. There should be a clear and concise cutting off point when it is deemed that professional responsibility has ended and the file may be "closed." It is also advisable to assign each file to a particular person to service. This would be done regardless of the fact that several persons might be expected to work on a particular case. It is not advisable to assign the file to two persons because of the chance that each will assume that the other has the duty of going ahead, and divided responsibility is not advisable.

There should probably be a physical segregation of files, in that the open files will be in one place and the closed files will be in another place. In view of the fact that clients' papers of considerable value may frequently be in open files, it is highly desirable that the open files should be kept in fireproof safes. This does require considerable filing space in safes and may not be practical in all instances.

Alphabetical arrangement

It is desirable, we believe, to arrange the open files in alphabetical order. This is because when one desires to go to the safe or file cabinet and get out a file he does not care to have to look up in an index for the number which would be necessary if the files were in numerical order. On the other hand, there is a substantial advantage to be gained by filing your closed files in numerical order. If you insist upon having each number accounted for and when a file is removed permanently, putting in a sheet of cardboard with the same number on it, then you will have a situation where your files can be audited and missing numbers will be detected automatically. Of course, at any given time, the "open" files will not be in the closed file sequence and these numbers will be missing from the cabinets containing the closed files, but the presence of these files can easily be verified and it will be possible to go through the entire filing system if there is any reason for it and determine whether or not all the files are present. Another reason for arranging the closed files in numerical order is that in this way the older files will automatically be in one place. This simplifies ultimate disposal of old files, which is a problem all to itself and which will not be discussed here.

It is quite advisable to have a rule that all files shall be put away every night. This would be especially important if putting away the files increases their protection, as would be the case if they are filed in a fireproof safe; but even if they are filed in ordinary filing cases, the discipline involved in putting away all files every night is an advantage.

Closing a file

When a file is ready for "closing," that is, it is deemed that the professional responsibility has terminated because the task has been performed or for some other reason the file is to be closed, then there are certain routine things which should be done. The first is to check for clients' papers, because now that the file is to be put away, there will be no further occasion to go through it and pick out papers which should be returned to the client. Some clients have a propensity for blaming their lawyer for all papers that are missing, especially about six months after the event. If you have a system whereby a third person checks through each file before it is closed and weeds out all clients' papers for return to the client, this possibility is minimized. There are several other procedures which are advisable at the time of closing. The first has reference to forms. It is considered good practice for a law office to have a separate "forms" file where extra copies of all documents which could be regarded as precedents for future work are filed analytically under subject headings. The time to check the file to see whether this has been done is when the file is about to be closed. Similarly, if the office has the practice of putting duplicate copies of memoranda concerning research in a special place for future reference, these duplicate copies should be checked for at this time. The final step is to approve the closing, making sure that professional responsibility is over. In a larger office this final step may be delegated to a separate person who must sufficiently visualize the task which was involved in the file to have reason-

[*Mr. Neuhoff is senior member of a law firm in St. Louis, Missouri, and Lecturer on Taxation at Washington University School of Law. His article is based on an address made by him before a meeting of the Arkansas Bar Association. The concluding part of his study, dealing with finding out how much it costs to do a given piece of work, will appear here next month.*]

able assurance that that task has been performed. It has been found advisable to have a rubber stamp with blocks for these various steps in order to facilitate checking.

Bookkeeping System

A bookkeeping system of a law office might well have the following functions:

1. To keep the bank account.
2. To keep the accounts between the firm or individual lawyer and the clients.
3. To keep account of the relationship of the partners to the firm and to each other.
4. To keep account of the relation of the firm (or lawyer) to the taxing authorities.

With reference to the bank account, you are here dealing with another party, namely the bank. This is a considerable safeguard for accuracy, since the bank, at least, will have modern business methods and mechanical aids to bookkeeping. If your accounts can be reconciled with the bank account, this is one assurance of accuracy. Our principal observations here with reference to the bank account are not on fundamentals, but are on shortcuts and, therefore, may or may not be adopted without infringing upon the principles which we laid out in the early part of our discussion.

Voucher checks are desirable. These may be either large detachable vouchers, where the checks are prepared on the typewriter in duplicate, or the voucher may consist of a block on the corner of the check, where the check is to be prepared by hand. If checks are sometimes prepared by the clerk on a typewriter, and sometimes prepared by the lawyer himself by hand, he will probably want to have a voucher block in the corner of his check rather than the large detachable voucher which practically requires preparation upon a typewriter.

Another expedient which is highly desirable is the use of the check register and deposit register. The check register is a loose-leaf book or page for listing all checks, and similarly a deposit register is a loose-leaf book or page for listing all deposits. These take the place of the familiar check stub. Use of a check-register system requires that the check be prenumbered by the printer and that all numbers be accounted for. It would, of course, be intolerable to have a check written with no notation made anywhere that such check was outstanding. However, since a check register will usually permit using but a single line for each check, it is obvious that a large number of checks can be presented to view in a check register, which is not the case with check stubs. Also, a check register may be used as the cash account, whereas if one has a check stub, he will probably be posting the items from the check stub to the cash account. Use as the cash account of the check register eliminates one operation and is considered desirable. Also one may use multiple columns with appropriate headings for the check register and similar columns with appropriate headings for the deposit register. The use of multiple columns is not a characteristic of the check-register system, however, since it could be used on any cash account.

Here again, we should learn to walk before we learn to fly. In Nazi Germany small businessmen were practically forced to use a bookkeeping system which embodied multicolumn bookkeeping to eliminate posting, and there is no objection to multicolumn bookkeeping, provided that it represents standard bookkeeping practice and not some "new invention." This means, therefore, that the column totals should be journalized and carried to ledger pages with precautions to provide that this will be done without error, or that if errors are made they will be detected. The double-entry bookkeeping system tends to disclose errors and facilitates finding them.

Accounts with client

Let us consider now the accounts between the firm or individual lawyer and the client. The primary objective, it would appear, should be to show the *total* relationship of the client to the office. This is a deviation from some published systems which seem to treat the job as the unit and if, for example, a client had three jobs in the office, these would not be related together, but there would be a separate series of debits and credits to the client for each separate job. I would not go so far as to say that this would not work in particular offices where there was a vast volume of relatively small affairs principally for different clients. However, in a typical law office it would seem to be quite undesirable. Instead, all of the entries affecting one client should be gathered together on one ledger page or in one place, so that it would be possible to inform the client by consulting this page or record as to how he stood with the firm as a whole.

Should we use an accrual system? If it were not for the income tax, accrual would probably be used in all but the simplest situations. The difficulty is that there is an income tax advantage in cash-basis accounting. On the cash basis, one is permitted to defer reporting of income until it is collected, even though it has been billed.

This tax advantage would furnish a good reason for using the cash-receipts-and-disbursements method. On the other hand, there is a tax disadvantage in the cash-receipts-and-disbursements method in that there is a lack of uniformity of income in various years more frequently on the cash method than on the accrual method. The lawyer himself has more control over the billing of clients than he has of the payment by the clients of the fees after they have been billed. Also there is a definite management advantage in accrual bookkeeping, because by use of it you know where you stand at all times and this is highly advisable where you have partners. It is a more useful tool to reflect non-cash items, such as depreciation. Probably the cash-receipts-and-disbursements method will continue to be used by the vast majority of law offices simply on account of the income tax advantage, coupled possibly with the fact that a more rudimentary knowledge of bookkeeping is involved. But where a decision is to be made and it is possible to introduce accrual bookkeeping, serious consideration should be given to its advantages.

Consideration might also be given to a system in which charges to clients are kept in a separate "memorandum account" and which is, therefore, not deemed a departure from the cash-receipts-and-disbursements basis. However, such systems must be handled with care and do not possess all of the advantages of a full double-entry set of books.

Another purpose of bookkeeping is to display or record the relationship of the partners to the firm and to one another. It is suggested that the relation-

ship should be formalized on the books; that is, contributed capital should be shown as a definite amount, and such assets as library and equipment should be capitalized and recorded. Here again, tax advantage pulls in one direction and good business procedure in another. There is a temptation to charge off new books, for example, as expense instead of capitalizing them because of the income tax advantage involved, assuming that it would be permissible. It is desirable to keep the firm accounts scrupulously separate from the personal accounts of the partners. Therefore, the partners should not pay their personal bills with firm checks. Payments of profits to partners should be made only after periodic determination that such profits exist. If drawings are to be permitted, they ought to be authorized in advance and in regular amounts and only as large as the firm can afford.

Another purpose which we have listed with reference to bookkeeping in a law office is to exhibit the relationship of the firm to the taxing authorities. We shall not go into that here further than to say that records which are required should be kept and that a double-entry system kept according to accounting principles commands respect of tax auditor and simplifies dealings with him.

Tulane Tax Institute, AICPA meeting in New Orleans

As a result of a particularly happy bit of planning, the Seventh Annual Tulane Tax Institute and the annual meeting of the American Institute of Certified Public Accountants will be held contiguously in New Orleans this month. The Tulane Institute runs from October 23 to 26, the AICPA from October 27 to 30.

In addition to its customary specialized session on taxation of oil and gas, Tulane will present sessions on "Family and Business Problems"; "Special Problems of Corporations" will fill one day, and the final day will cover tax problems of multi-state operations. Other subjects at Tulane will be "Determining Taxable Income Without Records," "Condemnation and other Involuntary Conversions," "Deductions for Individuals," and "Proper Handling of Potential Fraud Cases."

The Tulane speakers are, as usual, drawn from among the country's best-known tax lawyers and accountants. ☆

Survey shows 20 to 30% of CPAs' work is taxes

Most CPA firms handle tax work in a manner different from that accorded audit and other types of engagements, according to a survey recently conducted by the committee on professional statistics of the AICPA. Based on some 2,200 replies from 9,000 questionnaires sent out, tax work makes up (a median) 21 to 30% of all work. Some small offices reported that tax work was greater than 50% of their billing, but no firm with six or more CPAs did so much as 50% tax work. Sixty-four per cent of firms said they did no estate-planning work whatever.

Thirty-seven per cent of firms replying said their tax work was on the increase (25% said audit work leading to opinion reports was on the increase, 15% indicated that management service was increasing). Other auditing, including write-ups, was on the decrease in 40% of the firms, and 26% of them said audits leading to reports were decreasing.

With respect to fees for tax work, 24% said they had special rates for tax work; 54% billed directly on time basis or with adjustment for circumstances.

In general, these figures tend to confirm the general impression that the larger firms do more auditing, the smaller ones more tax work.

The survey also reveals a trend toward increasing numbers of engagements leading to expression of an opinion by the CPA, both in large and small firms. ☆

Fifth Annual Tax Conference at U. of Texas Law School

The University of Texas School of Law will hold its Fifth Annual Tax Conference on Estates, Trusts, Gifts, and Income Taxation at the School of Law on September 26-28. Judge John R. Brown, Circuit Judge of the U. S. Court of Appeals for the Fifth Circuit, will again preside.

California Tax Meeting Oct. 10

The eighth Annual Tax Accounting Conference will be held by the California Society of CPAs in Los Angeles' Ambassador Hotel October 10 and 11, and in San Francisco at the Palace Hotel on October 14 and 15. Mary E. Laniger of San Francisco is chairman.

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

The ground rules of tax planning for students and researchers with grants

by **H. HELMUT LORING**

The businessman, the property owner and the investor have learned never to make a move without consulting the tax man. Now a somewhat less well-heeled figure is joining them—the traditionally poverty-stricken graduate student with a scholarship or fellowship, the research worker with a grant from a foundation. They, too, had better be sure that the tax angles of their funds have been carefully planned. Mr. Loring, an Oakland, California, attorney, deals here with the areas that must be carefully studied: educational and research expenses, awards and prizes, and scholarships and fellowships. This article is adapted from a longer, fully annotated one in 45 California Law Review 153.

THE GROUP whose special tax problems are discussed here is numerically small and has little voice in the legislative process which produces our revenue law. The relative scarcity of case law indicates that its members do not often have the financial resources necessary to litigate their tax problems and that the deficiency amounts involved would normally be small.

It is particularly unfortunate therefore that there is no provision in the Code covering the deductibility of educational and research expenses. The few cases in this field have applied a much narrower test of "necessary" than is applied to the businessman and deny what are truly ordinary and necessary expenses of a student or teacher or researcher. We have it on the authority of Justice Cardozo that "reputation and learning are akin to capital assets"; that "the money spent in acquiring them is well spent," but that "it is not an ordinary expense of the operation of a business."[1]

Thus under the general rule, all expenses incurred in preparation for a career in life, or to better one's position, learning or reputation, are deemed to be of the non-deductible type. The proposed Regulations, Section 1.162-5(a)(2), provide that "Expenditures for education which are made primarily for the purpose of, or which have the result of, obtaining a position for the taxpayer; qualifying him to enter an employment or otherwise become established in a trade or business or a specialty therein; establishing or enhancing substantially his reputation in his trade or business; substantially advancing him in earning capacity, salary, status or position; or primarily fulfilling the general cultural aspirations or other personal purposes of the taxpayer are personal expenditures and are not deductible."

In only two areas have taxpayers been successful in their attempts to deduct educational expenditures, and their success is now reflected in the proposed Regulations under the 1954 Code. Where under state law teachers are required to take certain courses or undertake travel in order to retain their teaching qualifications or credentials, the expenses incurred in such travel, or for tuition, residence at a university, books and similar items have been held deductible. Similarly, expenses of attending refresher courses by persons engaged in a profession have been held deductible because incurred merely to keep proficient in a profession already acquired and not for the purpose of achieving a new status or position.

Much educational and research expense does not fit within either of these two areas where deductibility has been conceded. Two recent cases, for example, involved expenditures incurred in obtaining advanced degrees. In *Kamins* (25 TC 1238 (1956)), and in *Marlor* (27 TC No. 70 (7/26/56)), the taxpayers held temporary teaching positions at universities prior to the completion of the requirements for the Ph. D. degree in their fields. In both cases these taxpayers could retain their position only by diligently working toward the acquisition of the degree and by ultimately obtaining it. In both cases the expenses incurred in meeting the requirements for the doctoral degree were denied deductibility on the theory that these expenses were still part of the cost of general preparation for an academic career and therefore not the type of expenditure which is incurred to maintain a position already securely acquired. This reasoning is sound, since the distinction between the teaching assistant or instructor who has yet to obtain his final degree to qualify for a permanent academic career and the teacher who periodically must attend special courses to retain his teaching credential is quite realistic. The basis for the distinction lies in the nature of the expenditure, capital in the former case, current and ordinary in the second. Unfortunately, the cases have not always applied this test.

The Cardozo case said no

In *Cardozo*, 17 TC 3 (1951)), the Tax Court denied the deduction of expenses incurred on a trip to Europe by a professor of Romance languages. Beyond a mere statement by the court that the trip was undertaken "for the purpose of research and study" there is no indication of what was done during the sojourn in Europe, and whether the places and persons visited show a close relation to the taxpayer's special field. The main argument of the court was that since nothing in the university regulations required a professor to take such trips to maintain his present posi-

[1] Welch v. Helvering, 290 U.S. 111, 115-16 (1933). There is no doubt that Justice Cardozo thought such expenses to be necessary. "For many," he said, "they are the only tools with which to hew a pathway to success." *Ibid.*

tion, the expenses incurred were not necessary to his trade or business.

Similarly, a Ruling of the Treasury Department takes the position that the expenses of an instructor at a private secondary school on a study trip abroad are personal and therefore non-deductible. *Rev. Rul.* 55-412 points out that the travel was not required by the school as a condition for retaining employment with it and the expenses were therefore deemed personal. Yet the facts show that the school thought such travel abroad sufficiently important for its teachers that it granted them leave with pay for that purpose.

Untenable rule

Any rule imposing a test whereby educational expenses are deemed necessary and ordinary only if required by some state law would not only be grossly unfair but also quite untenable unless the statutory terms do not mean the same thing for the scholar as they do for the businessman. Two examples will illustrate the problem. Mr. X and Mr. Y are professors of political science. From what little authority there is we may assume that they can deduct their membership fees in professional societies, the cost of subscriptions to journals in their fields, and the cost of attending meetings of such groups as the American Political Science Association. They can also amortize the cost of learned treatises in their field.

Mr. X specializes in the Western European area and uses his sabbatical leave for a trip to Europe during which he collects material for publication and for enriching his lectures with his personal experience. Undoubtedly he will engage in some sightseeing along the way, but his travel schedule clearly shows that the main purpose of the trip is directly connected with his special field of study. Mr. Y is engaged in different research and soon discovers that the material available at the library of his own university is inadequate. He is informed that the materials are available at the library of a university in another part of the country where Mr. Y therefore spends his summer, incurring the expenses of the travel and of his stay while completing his research. Are X and Y entitled to deduct the expenses incurred in their scholarly enterprises?

It is submitted that the statutory term "necessary" is misconstrued in both the *Cardozo* case and this Revenue Ruling. In determining whether the expenses of a businessman are deductible, the courts have never considered whether or not a particular business expense was required by any state law or trade regulation. In *Welch* (290 U. S. 111, 113 (1933)), Justice Cardozo indicated that whether an expenditure is necessary is foremost a question to be answered by the taxpayer who incurs the expense and his judgment should not easily be discarded by the courts. The term has never been interpreted to mean legal or absolute necessity, but rather has been taken to require that the expense be reasonably appropriate and helpful to the taxpayer's business. If it is necessary in that sense, the expense cannot be a personal one. This is the test which should have been applied in *Cardozo* and in the Revenue Ruling.

Under the same test our suppositious professors, X and Y, must be allowed to deduct their respective expenses. Since they deemed them necessary in their profession, or they would not have incurred them, why should their judgment as to the necessity of the expenses not prevail? Independent research is an integral part of the curriculum in any advanced field of learning. Any teacher on the graduate level of education is measured in his effectiveness only partly by his class-room technique. His attainments in research are given at least equal weight. In other words, his profession is both the imparting of old and the acquisition of new knowledge. Expenses incurred in the latter pursuit are just as necessary as those incurred in the former.

Little needs to be said on the question whether these expenses are also "ordinary" within the meaning of the statute. In the experience of the group with which we here deal such expenses are a normal and recurring incident of their chosen profession and this is the decisive test.

Prizes and awards

The tax treatment of prizes and awards is regulated by statute for the first time by Section 74 of the Internal Revenue Code of 1954. As the senate committee report shows, a statutory regulation was deemed necessary because of certain decisions which held prizes awarded in a contest to be nontaxable gifts rather than taxable income.

Under the new statutory provisions of the 1954 Code, the general rule includes in gross income all amounts received as prizes or awards. Section 74(b) provides an exception for prizes and awards which meet a three-fold test; if such prize or award is (1) given primarily in recognition of past achievements in religious, charitable, scientific, educational, artistic, literary or civic fields; and (2) the recipient was selected without any action on his part; and (3) the recipient is not required to render substantial services as a condition for receiving it, it is excluded from gross income. The first test makes the exclusion provision inapplicable to television and other advertising prizes and give-aways. The second test makes all contest prizes includible in gross income and thus overrules by legislation *McDermott* (150 F. 2d 585 (D.C. Cir. 1945)) which had held the Ross Essay Prize of the American Bar Association excludible from gross income under the 1939 Code.

Taxation of scholarships

The tax treatment of scholarships and fellowships is regulated by statute for the first time in Section 117 of the 1954 Code. Under prior law, the question of whether such stipends could be excluded from gross income depended primarily on whether they could be classified as gifts.

Under the general rule of Section 117 of the 1954 Code, all amounts received to cover expenses incidental to such scholarships or fellowship grants, and to cover expenses incidental to such actually so expended, are excludible from gross income. However, there are also certain limitations imposed by this Section. If the recipient is a candidate for a degree at an educational institution meeting the requirements of Section 151(e)(4), he cannot exclude that portion of the scholarship or fellowship grant which is compensation for part-time teaching, research or other similar activity, though such activity be a condition to the award of the scholarship, unless such part-time research, teaching or other activity is required by the curriculum for all candidates for that degree.

If the recipient is not a candidate for a degree, the payments are still excludible from gross income, if the grantor is either a governmental agency or a tax exempt private organization as defined in Section 501(c)(3); but there is a quantitative limitation whereby the recipient can exclude only an amount equal to $300 times the number of

months for which the grant is given. No further exclusion is allowed after the individual has excluded amounts as scholarships or fellowship grants, while not a candidate for a degree, for 36 months, whether or not consecutive.

The Treasury has ruled (*Rev. Rul.* 55-554.) that where a granting institution adds an allowance for dependents to the grant, the total amount received is subject to Section 117 and its limitations on excludibility; the fact that such an added allowance is made does not enlarge the excludible amount under Section 117(b)(2)(B).

Section raises problems

The new statutory provision raises many problems. The first question which must be answered under this new Section is this: What is a scholarship or fellowship grant within the meaning of Section 117? The statute gives no definition, but according to the Regulations scholarships are amounts paid to a student to aid him in pursuing his studies; and fellowship grants are amounts paid to aid an individual in the pursuit of study or research. That these definitions will not be very helpful becomes immediately apparent when one explores the borderline between these new statutory concepts on the one hand and payments for services, gifts, prizes, and awards on the other.

Because of the many and varied forms in which stipends for research or study are given today, it will often be hard to distinguish scholarships and fellowship grants from salaries. An example will point out the difficulty.

Mr. Z is a graduate student in a physics department working for his doctoral degree. The institution receives grants from the Federal government to do nuclear research and in turn employs its graduate students to help in this task. After some time, Z and other graduate students are assigned research projects which are not only part of the governmental research program but also will serve as doctoral theses for these students. Are the amounts received by Z while working on what will be his doctoral thesis scholarships or fellowships grants? The test given by the Regulations is whether the primary purpose of the research or study is to further the education and training of the recipient in his individual capacity or to benefit the grantor. This test had already been hinted at in a Tax Court decision under pre-1954 law which ruled against the taxpayer on facts very similar to the example here. (*Banks*, 17 TC 1386 (1952)).

There is little doubt that the Commissioner will deny Z's claim to the benefits of Section 117 and will rule that the payments are salary for services.

It is to be hoped that the Treasury will be realistic in applying its Regulation. To make a fair decision whether the purpose of the research is to train the recipient of the grant or to benefit the grantor many factors must be weighed. For example, many scholarships and fellowships are given on condition that the recipient devote full time to his studies or research. Since it is such a common provision it is no evidence that the grant is compensation for services. Nor should the fact that the university may retain certain rights in the research product be held to show that the main purpose is the benefit of the university. After all, the university makes available laboratory facilities and equipment and office, library, etc. The prime purpose of a grant can be the education of the recipient and still the university may wish to retain the possibility of recovering some of the substantial costs it incurred.

The Fullbright fellow

Exploring further the often elusive borderline between fellowships and payment for services, let us consider the post-doctoral Fullbright fellow who is sent, for the period of an academic year, to a university abroad as a guest professor. He is paid in local currency the equivalent of the salary of a professor at the university where he will lecture and in addition receives amounts to cover transportation. Even though the amounts paid in local currency are superficially like a salary for teaching, it should be clear that they are received as fellowship grants within the meaning of Section 117. The Government itself has set up the disbursement of these funds in the form of a large-scale scholarship and fellowship program under the Fullbright amendment to the Surplus Property Act of 1944. It makes these grants not because it bargains for the specific activity of the individual recipient, but because of the beneficial effect in terms of the advancement of learning, exchange of ideas and fostering of friendly relations with other countries which results from the operation of the program as a whole. This seems to be the decisive element which establishes such payments as scholarships or fellowship grants within the meaning of Section 117.[2]

The Regulations[3] differentiate from scholarships and fellowship grants not only payments which are compensation for present services but also amounts received in consideration for past or future services. It would be difficult to argue that the continued salary paid to a professor during his sabbatical leave is not taxable income; it is part of the total consideration which he receives for his services as a faculty member. But consider this situation: a private secondary school feels that its teachers will benefit so greatly from study trips abroad that it gives them "leave of absence with pay" to undertake such trips. Could these amounts be deemed fellowships? The answer would depend on several factors. If it is in the nature of a sabbatical leave, that is, if the teachers are entitled to leave with pay after a given number of years of teaching at the school, it cannot be a fellowship. If the teacher is obligated, after taking such leave, to return to the institution for further teaching, it is not a fellowship. In the first instance the leave-pay is for past services rendered, while in the latter situation it is advance compensation for services to be rendered in the future. If neither is the case, and if the travel project on which the grant is conditioned is one designed to further the education and training of the recipient in his individual capacity, it is difficult to see why these payments should not be deemed fellowships within the meaning of Section 117. The fact that the added learning and experience of the teacher will redound to the benefit of the school which makes the grant, if the teacher returns to his former position, should not deprive these payments of their character as fellowship grants.

A complex of problems is raised by

[2] *But see* U.S. Reg. §§301.6316-1—306.6316-8, which provides for payment of income tax in foreign currency by Fullbright-fellows and which seems to assume that amounts received under such grants could be includible in gross income in their entirety.

[3] U.S. Treas. Reg. 1.117-4(c)(1).

[4] Section 501(c)(3) lists the following organizations: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office."

the necessity of distinguishing between scholarships and fellowship grants on one hand and awards and prizes under Section 74(b) of the 1954 Code and gifts on the other hand. The express reference to Section 117 in Section 74 indicates the possibility of overlap. The Regulations make it clear that once a grant is deemed subject to Section 117, and therefore excludible at least in part, the portion which could not be excluded under Section 117 cannot be excluded as a gift or as a prize or award. But this would not foreclose the argument that a *particular* amount received by a taxpayer is entirely a gift or a prize or award rather than a scholarship or fellowship grant; when the receipts exceed the excludible amounts under Section 117, the argument may seem worthwhile to the taxpayer.

Under the terms of most scholarships or fellowships the question of prizes and awards under Section 74(b) cannot arise because normally interested persons must make application for them. But there are post-doctoral research grants which are offered to individuals selected without any participation or application on their part and who remain ignorant of the fact that their name is even being considered until the grant is offered to them. The selection is made entirely on the basis of the past record of achievements of the individual. If, in addition, the recipient is left entirely free to decide what to do with the grant, that is, if there are no specific conditions relating to designated research projects, reports to the granting institution, or similar requirements which are common conditions to fellowships or scholarships, there may be a genuine question whether such amounts do not come within the exclusionary provisions of Section 74(b).

The answer can be found only by considering the every-day meaning of the words "fellowship grant" and "prize." The former implies a giving to further learning and scholarly endeavor, the latter is a gift in recognition of past achievement. The fact that the recipient is selected on the basis of his past record of achievements does not mean that the grant is made to reward him for them, but may and is more likely to mean that the donor expects future achievements, with the help of this grant, and this is a well-founded hope considering the recipient's past record. The absence of any conditions may be explained by the reasonable expectation of the donor that the recipient will without specific limitation apply the funds in a manner which meets the purposes of the donor. Thus, if the motive of the donor is carefully considered, it should not be hard to distinguish scholarships and fellowship grants from prizes and awards.

There is no doubt that the most difficult problems in the practical application of Section 117 will arise in the areas just discussed, having to do with the definition of the term "scholarships" and "fellowship grants" as used in this new section. But there are other problems to be considered.

The source of the grant becomes of special importance for persons who are

WHAT THE LAW SAYS

On prizes and awards

SECTION 74(a): *General rule.*—Except as provided in subsection (b) and in Section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.

Exception.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement, but only if—(1) the recipient was selected without any action on his part to enter the contest or proceeding; and (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award.

On scholarships and grants

SECTION 117(a): *General rule.*—In the case of an individual, gross income does not include (1) any amount received—(A) as a scholarship at an educational institution . . . or (B) as a fellowship grant, including the value of contributed services and accommodations; and (2) any amount received to cover expenses for travel, research, clerical help, or equipment, which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

Limitations.—Individuals who are candidates for degrees: In the case of an individual who is a candidate for a degree at an educational institution . . . subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates . . . for a particular degree as a condition to receiving such degree, such teaching, research, or other services are required of all candidates . . . for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of the paragraph.

Individuals who are not candidates for degrees: In the case of an individual who is not a candidate for a degree at an educational institution . . . subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within limitations provided in subparagraph (B).

(A) Conditions for exclusion.—The grantor of the scholarship or fellowship grant is an organization described in Section 501(c)(3) which is exempt from tax under Section 501 (a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) Extent of exclusion.—The amount of the scholarship or fellowship grant excluded under subsection (a)(1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution. . . . ☆

not candidates for a degree. The recipient of such a stipend cannot claim the benefits of Section 117 unless the grantor is a governmental agency or a private tax exempt institution as defined in Section 501(c)(3).[4] Although the committee reports do not mention this, Congress probably intended by this limitation to aid in distinguishing between fellowships and payments for services, a distinction quite difficult where the recipient of the payments is not a candidate for a degree. Grants made for research by organizations other than those under 501(c)(3) would probably in any event be more often payment for services than fellowships. By disqualifying all but those tax exempt groups which have traditionally been the administrators and disbursers of scholarship and fellowship programs, Congress has barred any attempts by other groups to bring their disbursements for research under Section 117.

It follows that if a labor union which is tax exempt under Section 501(c)(5) or a Chamber of Commerce which is tax exempt under Section 501(c)(6) makes a post-doctoral research grant, the recipient could not claim the benefits of Section 117. It is therefore advisable that whenever an organization not within Section 501(c)(3) wishes to make a genuine fellowship grant to a person not a candidate for a degree, this be done by channelling the gift through a qualified institution such as a university. If the university is then also charged with the selection of the recipient, and if the grant is not conditioned on the recipient doing research work which is specified in detail by the original donor of the fund, the amounts received partake of the benefits of Section 117 and are not payment for services.

One area in which advance planning may save taxes and will certainly save confusion is expenses. Because of the $300 a month limitation on persons who are not candidates for a degree, any money which is in fact received for travel, research, clerical help or equipment should be separately advanced by the donor and labeled as such.

Let us assume that a taxpayer, an eminent professor of sociology, receives a post-doctoral grant from a qualified foundation to study the social institutions of some remote and primitive tribe. He receives a total of $12,000 for one year and he incurs expenses for transportation and other travel costs in the amount of $6,000. In the first part of this article it has been shown that these expenses are deductible as the ordinary and necessary expenses of a scholar. Since only a portion of the amount received is to be included in gross income, deductible expenses incurred in connection with the fellowship grant should probably be allocated in the same ratio to excludible and includible portions of the grant. However, the Regulations are silent on this problem, and a taxpayer would certainly be entitled to see first whether it would be improper to deduct the entire amount of the expense. The whole problem is avoided quite simply if the donor institution makes an estimate of the expenses and expressly designates a portion of the grant to cover these expenses. Amounts so designated to cover expenses, and actually so expended, are excludible under Section 117(a)(2) and the quantitative limitation in Section 117(b)(2)(B), which allows the exclusion to persons who are not candidates for a degree only up to $300 times the number of months covered by the grant, does not apply to such expenses. Whether the second limitation of Section 117(b)(2)(B), which denies the exclusion after the taxpayer has had the benefits of Section 117 for 36 months, applies to expenses excludible under Section 117(a)(2) is not clear. The statutory language seems to mean that if a taxpayer who is not a candidate for a degree has excluded scholarships and fellowship grants under Section 117(a)(1) for 36 months, he can thereafter exclude neither further grants nor amounts expressly designated to cover expenses and actually so expended. But any month for which the taxpayer merely received such expense amounts excludible under Section 117(a)(2) does not count in the total of 36 months after which further exclusions are denied.

The great difficulty encountered in writing on problems in this area lies in the dearth of case law. Scholars are not litigious, and if they wanted to be, they could hardly afford it. But if the existing precedent was correctly evaluated, there is no doubt that the deep cleavage between those within and those without the ivory tower has, in this instance, redounded greatly to the detriment of those within. The tax collector, clearly, is *ante portas.*

The discussion of the tax treatment of expenses of scholars clearly shows that no more is needed to obtain just results than a recognition of the fact that our college and university instructors and professors are expected to be more than lecture note reproduction machines. Independent research and study in the specific field of each individual is an integral part of his duties, and the expenses incidental thereto are the ordinary and necessary expenses of his chosen profession. Once this fact is acknowledged, the statute means for the scholar exactly what it means for the businessman. That there are, in addition, the strongest considerations of public policy in favor of allowing the deduction of such research and study expenses hardly needs mention.

With regard to the other two areas of the law here discussed, the new statutory regulation of prizes and awards will not create many problems in its practical application. The new statutory regulation of scholarships and fellowships, on the other hand, will cause some difficulty due to the wide variety of grants for scholarly purposes which are available today. However, there is no doubt that Section 117 can fully perform its function of clarifying a formerly confused area of the revenue laws if it is applied with a keen understanding of academic life and of the operation of those tax exempt foundations which today disburse a substantial part of the funds which oil the wheels of scholarly enterprise in this country. ☆

New decisions affecting individuals

Wife liable on joint return which she neither authorized nor signed. [*Acquiescence*]. After taxpayer furnished her husband's accountant with information about her 1951 income, the accountant included it on a joint return without her knowledge or consent and signed her name to the return. Three months later she endorsed the refund check, and in a separate return for 1952, she stated that she filed a joint return for 1951. The Tax Court concluded that taxpayer acquiesced in and gave her tacit consent to the filing of a joint return for 1951 and was therefore jointly and severally liable for that year's deficiencies. She should be allowed the standard deduction, since it would be more than itemized deductions after two uncontested disallowances. However,

fraud penalties were denied; the mere waiver of restrictions on assessment of tax and fraud penalty was not proof of fraud. *Heim,* 27 TC 270, *acq.* IRB 1957-

Can't file joint return; new marriage took place before divorce became final. Taxpayer's first wife obtained a California divorce which had not become final on the date he married his second wife in Mexico. The court interprets the California law and holds that the second marriage was not valid and therefore the taxpayer and his second wife are not entitled to file a joint return. *Gersten,* 28 TC No. 84.

No penalty for underestimating; payments exceeded tax on previous year's return (1939 Code). Taxpayer's estimated tax payments were greater than the amount of tax shown on his return for the preceding year. The estimate, however, was less than the tax determined for the prior year. The circuit court holds that penalties for underestimation should not be assessed. The statute provides for a comparison of the estimated tax with the tax reported in the prior year, not that ultimately determined on audit. [Under the 1954 Code, also, there is no penalty if the estimate is based on the tax "shown on the return" for the preceding year.—*Ed.*] *Schwarzkopf,* CA-3, 7/10/57.

No double penalty for not filing estimate (old law). Taxpayer did not file a declaration of estimated tax for 1952. The Commissioner assessed penalties for failure to file a timely declaration and for substantial underestimation of tax. This court grants a refund on the ground that penalty for substantial underestimation of tax may not be imposed in addition to penalty for failure to file. [The Commissioner has announced he will not follow this rule.—*Ed.*] The court disallowed claimed expenses for failure of proof of their business nature. Nor did the taxpayer prove the year of worthlessness on a claimed stock security loss. *Erwin,* DC Ore., 5/10/57.

Double penalty (not filing and underestimate) unlawful. In accordance with previous decisions, the court holds that the Commissioner may not assess both the penalty for failure to file a declaration of estimated tax for 1953 and a penalty for underestimating the tax. It ordered a refund of the penalty for underestimation. [The Commissioner has announced that he is not following these cases. Under the 1954 Code, there is one penalty computed on the excess of tax due over payments.—*Ed.*] *Todd,* DC Ga., 6/6/57.

Penalty for failure to file upheld in spite of "dummy" return prepared by Collector. Taxpayer deposited a check with the Collector's office on 3/15/51. Later, when it was determined that the check was in payment of an estimated tax installment, the Collector on 12/13/51 prepared a "dummy" declaration of tax and applied the payment against taxpayer's 1951 income tax liability. However, the court holds the December dummy declaration was not timely. Penalties for failure to file a timely declaration for 1951 are sustained. *Speicher,* 28 TC No. 104.

Failure to file estimates for three years not excused by IRS inaction. Taxpayer, a new and used car dealer, left bookkeeping and tax work to a girl in the office, a bookkeeper who came in weekly and his brother-in-law who prepared income tax returns. He filed no estimates for 1951, 1952 and 1953. He argued that this was reasonable in view of his own ignorance and that of his advisors and because the IRS accepted the returns though it was obvious an estimate should have been filed. The court said merely there was no reasonable cause for failure to file and sustained the penalty, in addition to the penalty for substantial underestimate. *Hansen,* TCM 1957-113.

Misinterpretation of law not "reasonable cause" for failure to file. A manager with a fixed annual income of $10,000 filed no declaration of estimated tax for 1950. He contends that he interpreted the 1939 Code provision requiring an individual to file a return if his gross income was expected to exceed $4500 plus $600 for each exemption to mean that if a joint declaration could be filed, the income must exceed $9000 plus the available exemptions. The court holds the interpretation incorrect, and since ignorance of the law does not constitute reasonable cause, it sustains the penalty for failure to file. The court further holds that the filing of waiver Form 872 extending the statute of limitations for assessment also covers any additions and penalties determined within the period as extended. *Picard,* 28 TC No. 106.

Filing zero estimated tax declaration will avoid "failure-to-file penalty (Old Law). Each of four partners of a gambling casino filed a declaration of estimated tax showing an estimated income of zero for 1948. The Commissioner assessed penalties for failure to file in addition to the penalty for substantial underestimation. He argued that the partners did not attempt to make a bona fide estimate of their 1948 tax and that this amounted to a failure to file a declaration. The court disagrees, holding that zero declarations are proper declarations. Judges Murdock and Pierce dissent: recognizing a zero declaration exalts form over substance. [Penalty is assessed under the 1954 Code on the difference between amounts paid on the estimate and tax due; there is no specific additional penalty for failure to file.—*Ed.*] *Delsanter,* 28 TC No. 94.

Failure to file estimate not excused by lack of cash or IRS inaction in prior years. Taxpayers sought to excuse their failure to file 1950 estimates on the ground that they were short of cash and also that their failure to file in four prior years had brought no action by the IRS. Their accountant had told them that the IRS was not enforcing the Regulations on estimates. The Tax Court held that they had no reasonable ground for failing to file. *Marbul,* 28 TC No. 74.

SS benefits are support for dependency exemption. Social security benefits paid to the child of a deceased worker and used for the child's support must be considered as the child s own contribution toward his support in determining who, for dependency exemption purposes, furnished more than half of such support. *Rev. Rul.* 57-344.

Stepfather didn't prove greater contribution than father's for support of child. Taxpayer and his wife had living with them their daughter and the wife's son by a previous marriage, aged about four during year in question. Taxpayer claimed the stepson as a dependent, but the Court disallows the exemption. The child's father contributed about $700 a year. The total amount expended for support (including the father's contribution) the court finds could not possibly exceed $1,000, and this estimate is overly generous because it allocates about one fourth of the household expenses to the

child, which, the court notes, is not reasonable in view of his age. *Tucker*, TCM 1957-118.

Father denied exemption for children; failed to prove support. Taxpayer proved that he contributed $688 certainly, and probably $160 more, or a total of $848 toward the support of his two children. The amount contributed by his divorced wife, if any, who had custody of the children, was not shown. The court concludes taxpayer failed to carry his burden of proof that he contributed more than 50% of the total amount spent for the childrens' support. Dependency exemptions for the children are denied. *Owens*, TCM 1957-134.

Dependency credit for sister allowed. Based on the testimony and other evidence the court concludes that taxpayer contributed more than one-half of the support of his sister during 1953 and is therefore entitled to a dependency credit for her. *Dysleski*, TCM 1957-149.

Can't even get a one-half exemption for mother-in-law. Taxpayer made a novel but unsuccessful attempt to get some tax benefit for maintaining his mother-in-law for part of the year. He claimed a one-half exemption for her because she lived at his home from January to June. The court sustains the Commissioner's disallowance. *Glennon*, TCM 1957-148.

Flower growing a business, not a hobby; loss allowed. Taxpayer who had practiced as a patent attorney for many years in New York owned property in Virginia used as a summer home. He knew nothing about flower growing but was induced by a friend to undertake large-scale commercial growing, taxpayer to supply the land and capital and the associate to operate it. Taxpayer had three different managers in three years, incurred over $10,000 loss and finally abandoned the venture. The court holds the loss was not a hobby loss but incurred in a profit-making venture and so deductible. *Morton*, TCM 1957-101.

Adman's boat was used partly for pleasure and partly in chartering business. Taxpayer had been for some years one of the principal owners of an advertising agency. Due to poor health he decided to buy a boat, refurbish it, and charter it out with the idea of building up a business and retiring from advertising. In 1948, the year in question, he was still working at advertising. The court finds that the use of the boat was 40% for the chartering business (expenses allowable though he didn't obtain his first charter income until 1949) and 60% for personal. *Greist*, TCM 1957-125.

Bagel baker denied deduction for wages paid in "cash." Prior to 1951 it was customary in the bagel baking industry to pay workers a part of their wages in cash. These amounts were not reported on payroll tax returns. Although taxpayer, a bagel baker, followed this custom for the years 1948-1950, the court allows him to deduct only for those amounts shown on the payroll tax returns, since taxpayer offered no direct evidence to substantiate the excess payments. Fraud penalties assessed by the Commissioner are rejected, the court saying that there is nothing in the record to prove fraud. *East New York Sanitary Bagel Bakery*, TCM 1957-144.

Building inspectors not police; no exclusion of subsistence. The 1954 Code excludes (Section 120) up to $5 a day received as a statutory subsistence allowance by a police official. The Service holds that sanitary or building inspectors are not police even though they wear a police badge and are charged with the enforcement of some laws. *Rev. Rul.* 57-309.

State filing fee for electoral candidates deductible. A filing fee (three or five percent of the annual salary of the position sought required by the state of New Mexico from each candidate for election is a deductible state tax. *Rev. Rul.* 57-345.

Computation of medical expense allowable for two wives in one year. In the same year taxpayer's first wife died (over age 65) and he (under 65) remarried and filed a joint return with his second wife (also under 65). He incurred medical and drug expense for himself and both wives. He should separate the drug expense for his first wife from that for himself and his second wife. The 1% of adjusted gross income which cannot be deducted is allocated to each in proportion to total drug expense. The allowable amount so determined for the first wife, plus all her medical expense is fully deductible. However for himself and the second wife only the excess of the limited drug-plus-medical expense over 3% of adjusted gross income is deductible. *Rev. Rul.* 57-310.

Can't claim headquarters city for job was not tax home. Taxpayer claimed as expenses while away from home, unreimbursed meals and travel expense incurred while an employee from April to August. The employer required him to choose a headquarters city and reimbursed only expenses incurred in other areas. He chose Atlanta and therefore had to pay his Atlanta expenses himself. He claimed for tax purposes however that Nashville was his home. The court noted that he had been living in Atlanta with his wife (who obtained a job there) in a hotel when he took the job and later moved to an apartment there. True he had a rented home in Nashville during part of the year. But the court concludes that during the period of employment he was living in Atlanta and could not deduct expense there as incurred while away from home. *Riley*, TCM 1957-117.

Amount allowable for itemized deductions determined. In a series of cases in which taxpayer claimed itemized deductions, and in which the Commissioner disallowed them and substituted the standard deduction, the court finds, on the facts in each case, the amounts to be properly allowed as deductible expenses. *Scheftel*, TCM 1957-139; *Paccione*, TCM 1957-140; *Russo*, TCM 1957-141; *Saunders* TCM 1957-142; *O'Malley*, TCM 1957-143; *Power*, TCM 1957-146; *Quinlan*, TCM 1957-147; *Glennon*, TCM 1957-148; *McCormack*, TCM 1957-150; *Flynn*, TCM 1957-151; *Delaney*, TCM 1957-152; *McGovern*, TCM 1957-153.

Harness racing promoter allowed travel expenses. Taxpayer was employed in 1947 by a New York harness racing promoter to investigate possibilities of expanding harness racing operations in Florida, Arkansas, and Missouri. He claimed a deduction of $5000 for "traveling-entertaining" during the year. The court finds taxpayer's absence from New York was temporary and allows a deduction of $2500 under the *Cohan* rule for out-of-town travel, food, and lodging. No expenses were allowed for "entertainment." *Schoenbaum*, TCM 1957, 137.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

State legislatures show no signs of revising state tax rates downward

THIRTY-ONE STATES have increased the rates of one or more major state tax since January 1, 1956. With all but six state legislatures having completed their 1957 sessions, there is no indication that there is any reversal to be hoped for in the recent upward trend of state budgets and taxes. In fact, it is believed that state spending and revenues may exceed $22 billion in the next fiscal year (1958) as compared to $9 billion recorded ten years ago.

Significant changes

In a survey of significant changes in state tax structures since 1955 legislative sessions, the Tax Foundation, Inc., notes that almost all the states have made major revisions in rates to meet the fast-changing economic picture of today.

"Pressures exerted by a growing, prosperous population for additional schools, highways and other facilities," the Foundation's Tax Review states, "continue unabated. Bumper yields from state taxes have not been adequate to make ends meet, and many legislatures have had to increase taxes in 1956 or 1957 sessions to balance state budgets."

It now appears that the total number of tax measures enacted during 1957 sessions will be less than in 1955, when almost 3,000 tax law changes were recorded.

The expanding economy and state legislative action in earlier sessions, especially in 1955, boosted fiscal 1956 state tax collections (excluding unemployment compensation) to $13,375 million, or 15.3% over 1955 yields of $11,597 million. Since all indications point to a similar large increase in 1957 tax collections, a number of state legislatures deferred major tax action this year.

A total of 52 increases in the rates of major taxes took place in 24 states. Major changes in rates since 1955, listed by category, follow:

Income taxes

Kentucky, in 1956, imposed a graduated surtax rate of 10% to 30% on individuals; also changed corporate rates from flat 4.5% to 5% on net taxable income up to $25,000; 7% on income over $25,000. *Idaho,* in 1957, increased graduated rates of personal income tax, and imposed flat 8% plus 10% surtax on corporation income (replacing graduated tax formerly levied at 1.5% to 8%). *Kansas,* in 1957, raised corporation income tax rate from 2% to 3%. Raised personal income rates only in upper brackets, i.e., from $5,000 to $7,000, increased from 3.0% to 3.5%; over $7,000 (net income) increased from 4% to 5% in tax years beginning after 1956. *Maryland,* in 1956, increased corporation rates from 4.5% to 5.0% (additional revenue dedicated to finance new port authority). *Pennsylvania,* in 1956, increased corporation rates from 5% to 6% (1957 legislature extended 6% rate through 1958 and 1959 tax years). *Montana,* in 1957, increased graduated rates on individuals (from present 1% on first $1,000 with additional 0.5% each additional $1,000 up to 4% on seventh $1,000, to maximum 5% on net income in excess of $7,000). Reduced personal deduction from $1,000 to $600. Corporate rates increased from 3% to 5%. *Colorado* reduced tax credit granted corporations and individuals from 20% to 15%. Personal deduction increased from $600 to $750. *New York* extended for 1957 personal income tax credit of 15% on first $100 tax and 10% on next $200 (passed 1956). *Oregon* reduced personal tax slightly, with personal exemption increased from $500 to $600, and the 45% surtax on personal income repealed; graduated rates increased, resulting in substantial inclusion of surtax in graduated rates.

General sales taxes

Arkansas increased rate from 2% to 3%, effective February 15; *Maine* increased rate from 2% to 3%, effective July 1; *Rhode Island* increased rate from 2% to 3%, effective June 1 for one year; *Indiana* increased tax rate on income from wholesale sales from 0.25% to 0.375%; reduced income rate on retail merchants, dry cleaners and laundries from 0.5% to 0.375%; in *Florida,* sales of 10 cents and up are now subject to sales tax (previous minimum was $.19), as are clothing under $10, mixed drinks, malt beverages, cigarettes and oils and greases; *Pennsylvania* adopted (the only new major tax since January 1, 1956) a 3% selective sales tax passed by the 1956 legislature and made permanent in revised form by the 1957 session; *Iowa* retail sales and use tax dropped to 2% on July 1 (Governor vetoed extension of previous 2.5% rate); *Florida* has levied a new 1% tax on the sale, rental or use of motor vehicles after July 1, as part of the 1957 revision of its tax structure.

Gasoline taxes

Massachusetts (1956) increased rate from 5c to 5.5c per gallon, effective July 1. *Indiana* (1957) raised rate from 4c to 6c. *South Dakota* (1957) raised rate from 5c to 6c. *Utah* (1957) raised rate from 5c to 6c. *Nebraska* (1957) raised rate from 6c to 7c. *Oklahoma* (1957) raised rate (from June 1-Dec. 31, 1957) from 6.58c to 7.58c (highest rate in U. S.). *Montana* replaced a temporary 7c per gallon rate by a permanent 6c tax, effective January 16, 1958.

Cigarette taxes

New Jersey raised rate from 3c a pack to 5c. *Ohio* from 2c to 3c. *West Virginia* from 4c to 5c. *Montana* from 4c to 5c (in February, to pay for Korean bonus); from 5c to 8c (in March, effective July 1). *Wisconsin* from 4c to 5c; *Michigan* from 3c to 5c. *Vermont* from 4c to 5c. *Kansas* from 3c to 4c. *Nebraska* from 3c to 4c. *Wyoming* from 2c to 3c.

Alcoholic beverages taxes

Louisiana increased its tax on liquor from $1.58 to $1.68 per gallon in 1956. *Michigan* added a surtax of 4% to its distilled spirits tax beginning July 1. *Montana,* in 1957, increased its liquor taxes from 8% to 20% of retail selling

North Carolina Omnibus Tax Bill

A COMPREHENSIVE revision of the state tax system of North Carolina was undertaken by the 1957 state legislature, which drew up a 300-page omnibus bill based on the report of the State Tax Study Commission, which received the support of the governor. Principal purpose of the new legislation was to provide a better tax climate for business as part of a program to attract industry to the state.

Most important change is the revision of the formula for allocating income as the basis for the corporation income and franchise taxes. The new formula determines the taxable income of a corporation on the basis of property, payroll, and sales ratio in the state to totals for each of the three factors. Taxpayers are expected to save some $7 million annually. ☆

price. *Vermont* increased its tax on spirits from $3.60 to $5.10 per gallon and on fortified wines from $1 to $1.20 for the period beginning August 1. The *Illinois* liquor tax was raised from $1.00 to $1.02 per gallon, effective July 1.

Property taxes

Maryland will levy a state property tax for debt service costs on a $75 million loan authorized in 1956. *Montana* increased the state property tax 6 mills for state purposes and the legislature authorized a referendum on a proposal to impose an additional 6 mills state levy on property for support of the University of Montana. *North Dakota* has imposed a state property tax of not less than $600,000 yield annually to retire a $9 million bond issue for Korean veterans' bonus. *Colorado* increased property taxes in 1956 for the state hospital, state penitentiary, and land acquisition for a state college. *Kansas* enacted a blanket tax on taxable property, together with a tax of 5 mills on money, notes and other evidences of debt. *West Virginia*, in 1956, authorized an additional state property tax if existing revenues proved insufficient to meet the debt service requirements of a $10 million road construction bond issue. ☆

New state & local decisions

The following reports on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

No use tax on leased equipment rentals. Taxpayer sold heavy road building machinery and equipment at retail. The greater number of the sales were negotiated through lease agreements by which rentals paid by the lessee were applied against the final purchase price. Two-thirds or more of the transactions resulted in sales. The state assessed use taxes against the rentals paid on leased equipment on which the option to purchase had not been exercised on the basis that such equipment had been subjected to a use by rental on the part of the taxpayer. The court, however, holds that since the returned equipment was ultimately sold in the regular course of business, as was all property acquired by the taxpayer, the use tax could not be imposed. It reasoned that the use tax was applicable only to property brought into the state for use and not to that which was subject to the sales tax. *Brown*, Sp. Ct. Ia., 4/3/57.

Plane crash no "casualty" for Wisconsin. A Wisconsin resident purchased an airplane in 1954 for $2,100. Several months later while attempting a take-off, the plane was totally wrecked. Thereafter, he sold the plane for junk receiving $50 for it. On his 1954 income tax return he deducted $2,050 as a loss on sale of personal property not compensated for by insurance or otherwise. His claimed deduction was disallowed. Wisconsin's income tax statute allows the deduction of losses due to the destruction of property by fire, flood, or other casualty, but the board held that the taxpayer's loss did not come within the scope and meaning of the word "casualty" as used in the statute. It ruled that the legislature intended to include only destructive casualty classes such as fire and flood in the term "other casualty." *Bublitz*, BTA, Wisc., 4/23/57.

Custom-made draperies subject to sales tax. In the same building, taxpayer operated two separate departments, one for the sale of materials, the other for the making of draperies. In charging its customers, it made separate billings for materials and services. The taxpayer contended that it was engaged in two separate business, one of which, the selling of materials, was subject to the sales tax, and the other, a tax-exempt service business. The court however, rules that the two departments constituted a single business, engaged in a continuing transaction, since the transfer of ownership of the materials did not take place until the draperies were completed, delivered and accepted by the customer. Sales tax is due on the full price of custom-made draperies. *Smith-Bridgman & Co.*, Mich. BTA, 12/20/56.

Interest on refunds follows residence. Interest on tax refunds was received by taxpayer, a foreign corporation doing business in Wisconsin. Interest was on the refund of Wisconsin privilege dividend taxes received in 1948 and of Federal income taxes received in 1950. In both years, 100% of the taxpayer's apportionable income was attributable to Wisconsin. The assessment was based on the premise that the interest represented income from business since the adjustments in tax liability which gave rise to the refunds resulted from recomputation of the taxpayer's income from business. The court, however, held that the interest accrued not as a result of business operations but because of the statutes of the state and Federal governments. It emphasized that the tax obligations which were overpaid were imposed directly on the taxpayer and not upon property or transactions identified with property or business. Since the interest follows the residence of the taxpayer it must be deducted from total net income before applying the apportionment formula. *Aluminum Goods Mfg. Co.*, Wisc. Sp. Ct., 4/9/57.

Heavy penalty for cigarette tax evasion upheld. A Louisiana resident imported 25 cartons of cigarettes during the month of March 1954 and consumed them without affixing the stamps and paying the tax provided by state law. A judgment rendered in a summary proceeding required him to pay a tax of $20 plus a penalty of $500, interest and attorney's fees. The Louisiana cigarette tax statute includes in its definition of "dealer" any person who imports cigarettes into the state for consumption in the state. The Louisiana Supreme Court held that under this provision, which

it ruled constitutional, a person did not have to be in the business of buying and selling cigarettes to be liable for the tax. It further ruled that the tax was not an ad valorem tax and therefore was not restricted by constitutional uniformity and rate limitations. It found untenable the contention that the penalty was confiscatory and excessive. As an excise tax on the use and consumption of tobacco, it need not be measured by the value of the property, the court said. *Madigan,* Sp. Ct. La., 5/6/57.

California court rules on possessory interests. The assessment of local property taxes on the possessory interests of government contractors in personal property employed by them but belonging to the Federal government is invalid. In an oral opinion, the court held that on the assessment date, the property was merely in the temporary permissive custody of the contractors and was at all times under the direct control of Federal representatives. It ruled that there was no provision in California statutes whereby the custody of personal property for limited purposes or an alleged possessory interest in personal property had ever been recognized as taxable property. The court noted that the legislature had provided specifically for the taxation of possessory interests in real property, but made no mention of such interests in personal property. *General Dynamics Corp.* Also *Aerojet-General Corp.* Sup. Ct. L. A. Calif., 3/22/57.

Northwest Cement affirmed. The Minnesota Supreme Court upheld the income tax assessment on Northwestern States Portland Cement Co. This case, which has attracted much attention, involves taxes, penalties and interest of over $100,000 covering the period 1933-1948. On a three-factor formula basis 16.7373% of the company's income was allocable to Minnesota. The taxpayer denied it is subject to the tax jurisdiction of Minnesota and that in Minnesota it is engaged solely in interstate commerce. The taxpayer, an Iowa corporation, had a maximum of six employees in Minnesota during the years in suit. Two salesmen and an office employee were attached to an office maintained in Minneapolis. Three salesmen operated out of their homes in Minnesota. Orders, including those received at the Minneapolis office, were sent to Iowa for approval and shipments were made by railroad from Iowa direct to the purchaser in Minnesota. No warehousing facilities were maintained in Minnesota. The majority and dissenting opinions (two judges dissented) analyze the decided cases at length with major emphasis on the interstate commerce issue. The holding of the majority on the two principal points in the case may be summarized as follows: (1) The taxpayer is present in Minnesota in the jurisdictional sense since the company is engaged in a regular and systematic solicitation of business within the state through employees stationed there and their activity is evidenced by the considerable volume of business which the taxpayer is doing with Minnesota purchasers. "We can only conclude that the taxpayer has sufficient factual connections with localized activities and transactions within the state to comply with the requirements of due process." (2) A nondiscriminatory state tax on the net income of a foreign corporation derived from the conduct of business salely in interstate commerce is not invalid provided that the income subject to the tax is fairly apportioned in accordance with business activity and provided also that the incidence of the tax is not the privilege as such of engaging in interstate commerce. *Northwestern States Portland Cement Company,* Sp. Ct. Minn., 6/14/57.

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